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Sales and Other Dispositions of Assets

For use in preparing
1990 Returns

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Important Changes for 1990

Like-kind exchanges. Restrictions have been added to the rules allowing a tax-free exchange of like-kind property. If related parties exchange like-kind property, they must wait 2 years before either can sell or dispose of the property exchanged. See *Like-kind exchanges between related parties* in Chapter 1.

Foreign for U.S. real property exchange. If U.S. real property is exchanged for foreign real property, the exchange is not a tax-free exchange because the properties are not of a like-kind. See *Special rule for foreign real property exchanges* in Chapter 1.

Federal employees. Officers and employees of the executive branch of the federal government can limit the amount of gain recognized on property they must sell to comply with conflict-of-interest rules. See *Conflict-of-Interest Rules* in Chapter 1.

Introduction

If you trade or sell one of your assets, you may have a gain or loss on the transaction. In general, gains increase your taxable income, and losses decrease it. However, not all transactions result in taxable gains or deductible losses. This publication explains how to figure gain and loss on various transactions, and the tax results of them.

You may find other publications such as those listed below helpful. These publications offer additional information related to sales, exchanges, and other dispositions of assets.

Publication 523, Tax Information on Selling Your Home,

Publication 541, Tax Information on Partnerships,

Publication 550, Investment Income and Expenses (includes information on capital assets not used in a trade or business or for the production of income), and

Publication 537, Installment Sales. (Chapter 4 of this publication, under *Installment Sales*, explains how to figure and report gain that includes recapture of depreciation).

Free publications and forms. If you need information on a subject not covered in this publication, you may check our other free publications. To order publications and forms, call our toll-free telephone number 1-800-TAX-FORM (1-800-829-3676) or write the Internal Revenue Service (IRS) Forms Distribution Center for your area as shown in the income tax package.

Chapter 1 Transfers of Property

This chapter discusses the tax effects of transferring property. Some of the transactions included in this chapter are:

- Sales and exchanges of property,
- Involuntary conversions (exchanges), and
- Nontaxable exchanges.

Sales and Exchanges

A transaction must be a sale or exchange for any gain on it to be taxable or any loss to be deductible. A **sale** is a transfer of property for money or for a mortgage, note, or some other promise to pay money. An **exchange** is a transfer of property for other property or services. This section discusses these areas and points out how to tell which transactions are sales or exchanges and which are not.

Sale or lease. Some agreements that seem to be leases may really be conditional sales contracts. The intention of parties to the agreement can help you distinguish between a sale or lease.

There is no test or group of tests to prove what the parties intended when they made the agreement. You should consider each agreement based on its own facts and circumstances. For more information on leases, see Publication 535, *Business Expenses*.

Easements. Granting or selling an easement is usually not a taxable sale of property. Instead, the amount received for the easement is subtracted from the basis of the property. If only a part of the entire tract of property is permanently affected by the easement, only the basis of that part is reduced by the amount received. If it is impossible or impractical to separate the basis of the part of the property on which the easement is granted, the basis of the whole property is reduced by the amount received.

Any amount received that is more than the basis to be reduced is a taxable gain. The transaction is reported as a sale of property.

If you transfer a perpetual easement for consideration and do not keep any beneficial interest in the part of the property affected by the easement, the transaction will be treated as a sale of property. However, if you freely give an open space or scenic easement in perpetuity to a government or charity, it is treated as a charitable contribution and not a sale or exchange even if you keep a beneficial interest in the property affected by the easement.

Transferred property to satisfy debt. A transfer of property to satisfy a debt is a taxable exchange.

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Cancelled debt. A person's debt that is cancelled or paid by another person is not a sale or exchange. The cancelled or paid debt is generally income to the debtor unless it is intended as a gift. For information on a cancelled debt that is secured by property relating to a foreclosure, repossession, or abandonment, see *Foreclosure, Repossession, or Abandonment* in Chapter 2. For information on cancelled debts in general, get Publication 525, *Taxable and Nontaxable Income*.

Extended note maturity date. The extension of the maturity date of a note is not treated as an exchange of outstanding notes for new and different notes. Also, it is not a closed and completed transaction upon which a gain or a loss is figured. This treatment applies to notes you hold under an agreement that states you will not redeem your notes during any extension period but will keep them until all other notes are retired or the notes can be retired.

Transfer to an executor or administrator. The transfer of property to an executor or administrator, or to the heirs or beneficiaries, upon the death of an individual is not a sale or exchange. No gain or loss is recognized (included in taxable income) on the transfer.

Bankruptcy. A transfer of property to a trustee of a bankrupt estate is a nontaxable transfer. For more information, see *Transfer Between Debtor and Estate* in Publication 908, *Bankruptcy and Other Debt Cancellation*.

Foreclosure and repossession. A transfer of property to a mortgagee (lender) or creditor through foreclosure or repossession is a sale or exchange even if the owner voluntarily conveys the property to the mortgagee or creditor. For more information, see *Foreclosure, Repossession, or Abandonment* in Chapter 2.

Involuntary Conversions (Exchanges)

An involuntary conversion (exchange) occurs when your property is destroyed, stolen, condemned, or disposed of under the threat of condemnation, and you receive other property or money in payment, such as insurance or a condemnation award. Involuntary conversions are also called **involuntary exchanges**.

You do not report the gain if your property is involuntarily converted and you receive property that is similar or related in service or use to it. Your basis for the new property is the same as your basis for the converted property. Thus, the gain on the current transaction is deferred until a taxable sale or exchange occurs.

Condemnations

Condemnation is the process by which private property is legally taken, without the owner's consent, for public use. The property may be taken by the federal government, a state government, a political subdivision, or a private organization that has the power to legally take the property. The owner receives money or property in exchange for the taken property. A condemnation is like a forced sale, the owner being the seller and the condemning authority being the buyer.

Example. A local government authorized to acquire land for public parks told you that it wished to acquire your property. After the local government took action to condemn your property, you went to court to keep your property. But the court decided in favor of the local government. The government took your property and paid you an amount fixed by the court. This is a condemnation of private property for public use.

Threat of condemnation. You are under threat of condemnation if a representative of a government body or a public official authorized to acquire

property for public use tells you that the government body or official has decided to acquire your property. From this you have reasonable grounds to believe that if you do not sell voluntarily, your property will be condemned.

You are under threat of condemnation if you sell your property to someone other than the condemning authority, provided you have reasonable grounds to believe that your property will be condemned. If the buyer of this property knows it is under threat of condemnation at the time of purchase and sells the property to the condemning authority, such a forced sale will also qualify as a condemnation.

Reports of condemnation. You are under threat of condemnation if you learn of a decision to acquire your property for public use through a report in a newspaper or other news media, and this report is confirmed by a representative of the government body or public official involved. You must have reasonable grounds to believe that they will take necessary steps to condemn your property if you do not sell voluntarily. If you relied on oral statements made by a government representative or public official, the Internal Revenue Service may ask you to get written confirmation of the statements.

Example. Your property lies along public utility lines. The utility company has the authority to condemn property. You are notified by them that they intend to acquire your property by negotiation or condemnation. Your property is under threat of condemnation when you receive the notice.

Property voluntarily sold. A voluntary sale of your property may be treated as a forced sale that qualifies as a condemnation if the property had a **substantial economic relationship** to property of yours that was condemned. A substantial economic relationship exists if together the properties were one economic unit. You must show that a suitable nearby property of a like kind (the same or similar) to the condemned property is not available, and you cannot continue to do business as before.

This treatment will not apply to you if you do not own both properties.

Easements. If you grant an easement on your property (for example, a right-of-way over it) under condemnation or threat of condemnation, you are considered to have made a forced sale, even though you keep the legal title. Although you figure gain or loss on the easement in the same way as a sale of property, the gain or loss is treated as a gain or loss from a condemnation. See *Gain or Loss from Condemnations*, later.

Example. The Department of Agriculture is authorized to acquire any lands or interest in them for the protection of the historic, cultural, and scenic values of an area. The Department informed you in writing that condemnation proceedings will be started unless you agree to sell voluntarily a scenic easement over your property. You have made a forced sale when you give up any use of your property by the sale.

Condemnation award. A condemnation award is the money you are paid or the value of other property you receive for your condemned property. The award is also the amount you are paid for the sale of your property under threat of condemnation.

Amounts withheld from award. Amounts withheld from the award to pay your debts are considered paid to you. Amounts paid directly to the holder of a mortgage or other lien (claim) against your property are part of your award, even though the debt attaches to the property and is not your personal liability. See *Special assessment withheld from award*, later.

Example. The state condemned your property for public use. The award was set at \$200,000. The state paid you only \$148,000 because it paid \$50,000 to your mortgage holder and \$2,000

accrued real estate taxes. You are considered to have received the entire \$200,000 as a condemnation award.

Net condemnation award. A net condemnation award is the total award you received, or are considered to have received, for the condemned property minus your expenses of obtaining the award. If only a part of your property was condemned, you must also reduce the award by any severance damages and any special assessment levied against the part of the property you retain. These are discussed later under *Severance damages* and *Special assessment withheld from award*.

Interest on award. If the condemning authority pays you interest for its delay in payment of your award, it is not part of the condemnation award. You should report the interest separately as ordinary income.

Payments to relocate. Payments you receive to relocate and replace housing because you have been displaced from your home, business, or farm as a result of federal or federally assisted programs are not part of the condemnation award. Do not include them in your income. The replacement housing payments are added to the cost of your newly acquired property.

Severance damages. Severance damages are compensation paid to you if part of your property is condemned and the value of the part you keep is decreased because of the condemnation.

If part of your property is condemned, the part you keep may be damaged as a result of the condemnation. For example, you may receive severance damages if your retained property will be subject to flooding. Severance damages may also be given to you if you must replace fences, dig new wells or ditches, or plant trees to restore your remaining property to the same usefulness it had before the condemnation.

The contracting parties should agree on the amount of the severance damages and put that in writing. If this is not done, all the proceeds from the condemning authority are considered awarded for your condemned property.

Example. You transferred part of your property to the state under threat of condemnation. To figure the total award for the condemned part, you and the condemning authority agree to severance damages for the part you kept. The contract you and the authority signed showed only the total award. It did not specify a fixed sum for severance damages. However, when the condemning authority paid you the award, it gave you closing papers that clearly showed that part of the award was for severance damages. You may treat this part as severance damages.

You may not make a completely new allocation of the total award after the transaction is completed. However, you may show how much of the award both parties intended to be for severance damages. The severance damages part of the award is determined from all the facts and circumstances.

Treatment of severance damages. You must first reduce your severance damages by your expenses in obtaining the damages. You then reduce them by any special assessment levied against the remaining part of the property if the assessment was withheld from the award by the condemning authority. The balance is your net severance damages. You then reduce the basis of the remaining property by your net severance damages.

If the amount of severance damages is based on damage to a specific part of the property you kept, you may reduce only the basis for that part by the net severance damages. If your net severance damages are more than the basis of your retained property, you have a gain. You may choose to postpone the gain by purchasing replacement property. See the later discussion, *Postponement of gain*.

If you restore the remaining property to its former use, you can choose to treat the cost of restoring it as the cost of replacement property. You can also make this choice if you spend the severance damages, together with other money you receive for the condemned property, to acquire nearby property that will allow you to continue your business. If suitable nearby property is not available and you are forced to sell the remaining property and relocate in order to continue your business, see *Property voluntarily sold*, discussed earlier.

Expenses of obtaining a condemnation award and severance damages. Subtract the expenses of obtaining a condemnation award, such as legal, engineering, and appraisal fees, from the amount of the total award. You also subtract the expenses of obtaining severance damages from the severance damages paid to you. If part of your condemnation award is for severance damages, determine which part of your expenses is for each part of the award. If you cannot do this, you must make a proportionate allocation.

Example. You receive a condemnation award. One-fourth of it was stated in the award as severance damages. You had legal expenses in connection with the entire condemnation proceeding. You cannot determine how much of your legal expenses is for each part of the award. You must allocate one-fourth of your legal expenses to the severance damages and the other three-fourths to the award for the condemned property.

Special assessment withheld from award. When part of your property is condemned, you must reduce the condemnation award by the expenses of obtaining the award and by any amount withheld because of a special assessment levied against the remaining property. An assessment may be levied if the remaining part of your property is benefited by the improvement resulting from the condemnation. Examples of improvements that may cause a special assessment are widening of a street or installation of a sewer.

The assessment must be withheld from the award. The award cannot be reduced by any assessment levied after the award is made, even if the assessment is levied in the same year the award is made.

Example. To widen the street in front of your home, the city acquired 25 feet of your land. You were awarded \$5,000 for this and spent \$300 to get the award. Before paying the award, the city levied a special assessment of \$700 for the street improvement against your remaining property. The city then paid you only \$4,300. Your net award is \$4,000 (\$5,000 total award minus \$300 expenses in obtaining the award and \$700 for the special assessment withheld).

If the \$700 special assessment were not withheld from the award, and you were paid \$5,000, your net award would be \$4,700 (\$5,000 minus \$300). The net award is not changed, even if you later paid the assessment from the amount you received.

Severance damages included in award. If severance damages are included in the award, you must first reduce the severance damages by the special assessment withheld. Any balance is used to reduce the condemnation award.

Example. Assume that in the previous example you were awarded \$4,000 for the condemned property and \$1,000 for severance damages. You spent \$300 to obtain the severance damages. A special assessment of \$800 was withheld from the award. The \$1,000 severance damages are reduced to zero by first subtracting the \$300 expenses and then \$700 of the special assessment. Your award for the condemned property, \$4,000, is reduced by the \$100 balance of the special assessment, leaving a net condemnation award of \$3,900.

Gain or Loss from Condemnations

If your net condemnation award is more than the adjusted basis of the condemned property, you have a gain. You may postpone reporting the gain. If your award is less than your adjusted basis, you have a loss. If your loss is from property you held for personal use, you cannot deduct the loss. You must report any deductible loss in the tax year in which it happened.

How to figure gain or loss. If your property was condemned, you must figure your gain or loss by comparing the adjusted basis of your condemned property with the award you received minus the expenses of obtaining it.

Part business or part rental. If you used part of your condemned property as your home and part as business or rental property, you must treat each part as a separate property and figure your gain or loss separately for each part because gain or loss may be treated differently.

Some examples of this type of property are a farm or ranch you operate and live on, a building in which you live and operate a grocery, or a building in which you live on the first floor and rent out the second floor.

Example. You sold your building for \$24,000 under threat of condemnation to a public utility company that had the authority to condemn. You rented half the building and lived in the other half. You paid \$25,000 for the building and spent an additional \$1,000 for a new roof. You claimed allowable depreciation of \$4,600 on the rental half of the property. You spent \$200 in legal expenses to obtain the condemnation award. You figure gain or loss as follows:

	Residential part	Business part
Amount of award received	\$12,000	\$12,000
Minus: Legal expenses, \$200	100	100
Net condemnation award	\$11,900	\$11,900
Minus:		
Adjusted basis of residential part:		
1/2 of original cost, \$25,000	\$12,500	
1/2 of cost of roof, \$1,000	500	
Adjusted basis, residential part	\$13,000	
Adjusted basis of business part:		
1/2 of original cost, \$25,000		\$12,500
1/2 of cost of roof, \$1,000		500
Total		\$13,000
Minus: Depreciation		4,600
Adjusted basis, business part		\$8,400
Loss on residential property	\$ 1,100	
Gain on business property		\$ 3,500

The loss on the residential part of the property is not deductible.

Condemnation of part of property. If part of your property is condemned, you must take into account any special assessment levied against the part of the property you keep if the assessment was withheld from your condemnation award. You must also consider any severance damages that are stated as part of the award.

Postponement of gain. Do not report the gain on condemned, damaged, destroyed, or stolen property if you receive property that is similar or related in service or use to it. Your basis for the new property is the same as your basis for the old property.

Choosing to postpone gain. You must ordinarily report the gain if you receive money or unlike property as reimbursement. You can choose to postpone reporting the gain if you purchase property that is similar or related in service or use to the condemned, damaged, destroyed, or stolen property, or you purchase

controlling interest (at least 80%) in a corporation owning property that is similar or related in service or use to the property within a specified replacement period, discussed later. To postpone all the gain, the cost of your replacement property must be equal to or more than the amount realized (reimbursement) for the condemned, damaged, destroyed, or stolen property.

If you are a member of a partnership or a shareholder in a corporation that owns the condemned, damaged, destroyed, or stolen property, only the partnership or corporation, and not you, can choose to postpone reporting the gain.

Replacement period. To postpone reporting your gain from a condemnation you must buy replacement property within a specified period of time. This is the "replacement period."

Condemnation. The replacement period for a condemnation begins on the earlier of:

- 1) The date on which the condemned property was disposed of, or
- 2) The date on which the threat of condemnation began.

The replacement period ends 2 years after the close of the first tax year in which any part of the gain on the condemnation is realized.

If real property held for use in a trade or business or for investment (not including property held primarily for sale) is condemned, the replacement period ends 3 years after the close of the first tax year in which any part of the gain on the condemnation is realized.

Replacement property acquired before the condemnation. If you acquire your replacement property after there is a threat of condemnation but before the actual condemnation, and you still hold the replacement property at the time of the condemnation, you acquired your replacement property within the replacement period. Property you acquire before there is a threat of condemnation does not qualify as replacement property acquired within the replacement period.

Example. On April 3, 1989, city authorities notified you that your property would be condemned. On June 5, 1989, you acquired property to replace the property to be condemned. You still had the new property when the city took possession of your old property on September 5, 1990. You made a replacement within the required replacement period.

Extension. You may get an extension of the replacement period if you apply to the District Director of the Internal Revenue Service for your area. You should apply before the end of the replacement period. Your application should contain all the details about the need for the extension. You may file an application within a reasonable time after the replacement period ends if you can show reasonable cause for the delay. An extension of time will be granted if you can show reasonable cause for not making the replacement within the regular period.

Ordinarily, requests for extensions are granted near the end of the replacement period or the extended replacement period. Extensions are usually limited to a period of one year or less. The high market value or scarcity of replacement property is not a sufficient reason for granting an extension. If your replacement property is being constructed and you clearly show that the replacement or restoration cannot be made within the replacement period, you will be granted an extension of the period.

Time for assessing a deficiency. If you choose not to recognize gain from a condemnation, any deficiency for any tax year in which part of the gain is realized may be assessed at any time before the expiration of 3 years from the date you notify the District Director for your area that you are replacing the condemned property, or

intend not to replace, within the required replacement period.

Gain or Loss from Sales and Exchanges

Gain or loss is usually realized when property is sold or exchanged. A **gain** is the excess of the amount you realize from a sale or exchange of property over its adjusted basis. A **loss** is the excess of the adjusted basis of the property over the amount you realize.

Basis. The cost or purchase price of property is usually its basis for figuring the gain or loss from its sale or other disposition. However, if you got the property by gift, inheritance, or in some way other than by buying it, you must use a basis other than its cost.

Adjusted basis. The adjusted basis of property is your original cost or other basis plus certain additions, and minus certain deductions such as depreciation and casualty losses. See *Adjusted Basis* in Publication 551, *Basis of Assets*. In determining gain or loss, the cost of transferring property to a new owner, such as selling expenses, is added to the adjusted basis of the property.

Amount realized. The amount you realize from a sale or exchange is the total of all money you receive plus the **fair market value** of all property or services you receive. The amount you realize also includes any of your liabilities that were assumed by the buyer and liabilities to which the property you traded is subject, such as real estate taxes or a mortgage.

Fair market value. Fair market value is the price at which the property would change hands between a buyer and a seller when both have reasonable knowledge of all the necessary facts and neither is required to buy or sell. If parties with adverse interests place a value on property in an arm's length transaction, that is strong evidence of fair market value. If there is a stated price for services, this price is treated as their fair market value, unless there is evidence to the contrary.

Example. In your business you used a building that cost you \$70,000. You made certain permanent improvements at a cost of \$20,000 and deducted depreciation totaling \$10,000. You sold the building for \$100,000 cash, plus property having a fair market value of \$20,000. The buyer assumed the current real estate taxes of \$3,000 and a mortgage of \$17,000. The selling expenses were \$4,000. Your gain on the sale is figured as follows:

Amount realized:	
Cash	\$100,000
Property received (fair market value)	20,000
Real estate taxes (assumed by buyer)	3,000
Mortgage (assumed by buyer)	17,000
Amount realized	\$140,000
Adjusted basis:	
Cost of building	\$ 70,000
Improvements	20,000
Total	\$ 90,000
Minus: Depreciation	10,000
Adjusted basis	\$ 80,000
Plus: Selling expenses	4,000
Gain on sale	\$ 56,000

Amount recognized. The amount you realize (receive) from a sale or exchange of business or investment property may not always be recognized (included in income) for tax purposes. Generally, gains from the sale, exchange, or other disposition of the property must be included in gross income and losses from these transactions are deductible. However, there are exceptions to

this rule, as discussed later under *Nontaxable Exchanges*.

Life estates, etc. The entire amount you realize from the disposition of a life interest in property, an interest for a set number of years, or an income interest in a trust, is a taxable gain if you first got the interest as a gift, inheritance, or transfer in trust. Your basis in the property is considered to be zero. This rule does not apply if all interests in the property are disposed of at the same time.

Example 1. Your father dies, leaving his farm to you for life, with a remainder interest to your younger brother. You decide to sell your life interest in the farm. The entire amount you receive is a taxable gain. Your basis in the farm is disregarded.

Example 2. The facts are the same as in Example 1, except that your younger brother joins you in selling the farm. Because the entire interest in the property is sold, your basis in the farm is not disregarded. Your taxable gain is an amount equal to your share of the sales price minus your adjusted basis in the farm.

Nontaxable Exchanges

Certain exchanges are nontaxable. This means that any gain from the exchange is not taxed, and any loss cannot be deducted. In other words, even if you realize a gain or loss on the exchange, it will not be recognized (included in income) for tax purposes until you sell or dispose of the property you receive.

Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To be nontaxable, a like-kind exchange must meet **all six** of the following conditions:

One. The property must be business or investment property. Both the property you trade and the property you receive must be held by you for business or investment purposes. Neither may be used for personal purposes, such as your home or family car.

Two. The property must not be property held for sale. Neither the property you trade nor the property you receive may be property you sell to customers, such as merchandise. It must be property held for investment or property held for productive use in your trade or business. Machinery, buildings, land, trucks, and rental houses are examples of property that might qualify. Inventories, raw materials, accounts receivable, and real estate that dealers hold for sale to customers are examples of property that would not qualify.

Three. There must be an exchange of like property. The exchange of real estate for real estate and the exchange of personal property for similar personal property are exchanges of like property. For example, the trade of an apartment house for a store building, or a panel truck for a pickup truck is a like-kind exchange.

An exchange of city property for farm property, or improved property for unimproved property is a like-kind exchange.

The exchange of real estate you own for a real estate lease that runs 30 years or more is a like-kind exchange. However, not all exchanges of interests in real property qualify. The exchange of a life estate expected to last less than 30 years for a remainder interest is not a like-kind exchange.

An exchange of a remainder interest in real estate for a remainder interest in other real estate is a like-kind exchange if the nature and character of the two property interests are the same.

An exchange of personal property for real property does not qualify as a like-kind exchange. For example, an exchange of a piece of machinery for

a store building would not qualify. The exchange of livestock of different sexes also does not qualify.

An exchange of the assets of a business for the assets of a similar business cannot be treated as an exchange of single property for single property. Whether you engaged in a like-kind exchange depends on an analysis of each asset involved in the exchange.

If the like-kind exchange includes the receipt of money or unlike property, you may still have a taxable gain (see *Partially nontaxable exchange*, later).

Four. The property must be tangible property. The rules for like-kind, nontaxable exchanges do not apply to exchanges of stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest, or the exchange of partnership interests. However, you may have a nontaxable exchange of corporate stock. See *Exchanges of Corporate Stocks*, later in this publication.

Five. The property must meet the identification requirement. The property to be received must be identified on or before the day that is 45 days after the date you transfer the property given up in the exchange. The identification requirement may be met by designating the property to be received in the contract between the parties. Also, the identification requirement will be satisfied if the contract specifies a limited number of properties that may be transferred and the particular property to be transferred will be determined by contingencies beyond the control of both parties.

For example, if the executed contract for transfer of property provides that you will transfer real estate to Mary Brown in exchange for property A if zoning changes are approved and property B if the zoning changes are not obtained, the identification requirement is satisfied.

Six. The exchange must meet the completed transaction requirement. The property must be received on or before the earlier of:

- The 180th day after the date on which you transfer the property given up in the exchange, or
- The due date, including extensions, for your tax return for the tax year in which the transfer of the property given up occurs.

Binding contract. Rules five and six above apply to:

- Transfers made after July 18, 1984, if the property to be received in the exchange is identified in a binding contract in effect on June 13, 1984, and at all times thereafter before the transfer, and
- Transfers made before July 19, 1984, if the property to be received in the exchange is not received before 1989.

For any transfers before July 19, 1984, which you treat as part of a like-kind exchange, the period for assessing any tax attributable to that exchange will not expire before 1980.

Like-kind exchanges between related parties. New rules limit whether certain exchanges made between related parties after July 10, 1989, are nontaxable. These rules affect both direct and indirect exchanges. As with other like-kind exchanges, when related parties exchange like-kind property, no gain or loss is recognized (included in income). Under the new rules, however, if either party disposes of the property within 2 years after the exchange, then the exchange is disqualified from nonrecognition treatment. The gain or loss must then be recognized as of the date of disposition of the property.

Related parties. Under these rules, a related party includes a member of your family (spouse, brother, sister, parent, child, etc.) and a corporation in which you have more than 50% ownership

or a partnership in which you directly or indirectly own a more than 50% interest of the capital or profits. For more information on related parties, see *Sales and Exchanges Between Related Parties* in Chapter 2.

Example. You use a panel truck in your house painting business. Your sister is a landscaper who uses a station wagon in her business. The fair market value (FMV) of your truck is \$7,000 and its adjusted basis is \$6,000; the FMV of your sister's station wagon is \$7,200 and its adjusted basis is \$1,000. In December 1990, you exchange vehicles with your sister. This is a like-kind exchange in which no gain or loss is recognized.

In January 1991, you sell the station wagon to a third party for \$7,200. Since you sold the station wagon within 2 years after the exchange, you must recognize the gain from the like-kind exchange you made with your sister. That gain is \$1,200 (\$7,200 FMV of your sister's station wagon minus \$6,000, adjusted basis of your truck) and must be included in your income for 1991, the year of the sale. You must also report any gain you realized on the sale of the station wagon. In this case, however, the gain is zero because the \$7,200 sales price equals the increased basis of \$7,200 (\$6,000 plus \$1,200 recognized gain) for the station wagon.

In addition, your sister must recognize her gain on the like-kind exchange. That gain is \$6,000 (\$7,000 FMV of your truck minus \$1,000 adjusted basis of her station wagon) and must be included in her income for 1991, the year the station wagon was sold. Her basis in the truck would then be increased to \$7,000 (adjusted basis of \$1,000 plus \$6,000 recognized gain.)

Special rule for 2-year holding period. The 2-year holding period begins on the date of the last transfer of property which was part of the like-kind exchange. If the holder's risk of loss on the property is substantially diminished during any period, however, that period is not counted toward the 2-year holding period. The holder's risk of loss on the property is substantially diminished by:

- A put on the property,
- Another's right to acquire the property, or
- A short sale or other transaction.

A **put** is an option that entitles the purchaser to sell, at any time before a specified future date, property such as a stated number of shares of stock at a specified price.

A **short sale** is the sale of property you generally do not own. You borrow the property to deliver to a buyer and at a later date, you buy substantially identical property and deliver it to the lender.

Exceptions to the related party rules. The following kinds of property dispositions are excluded from the limits on nontaxable like-kind exchanges between related parties:

- 1) Dispositions due to the death of either related person,
- 2) Involuntary conversions, or
- 3) Exchanges or dispositions if it is established to the satisfaction of the IRS that the main purpose is not the avoidance of federal income tax.

Special rule for foreign real property exchanges. For transfers after July 10, 1989, real property located in the United States and real property located outside of the United States are no longer considered like-kind property. Therefore, if you exchange foreign real property for property located in the U.S., the exchange cannot be treated as a nontaxable like-kind exchange.

Exception. This rule does not apply to the replacement of condemned real property. Foreign and U.S. real property can still be considered like-kind under the rules for replacing condemned property to postpone gain on the condemnation.

See *Gain or Loss from Condemnation, under Involuntary Conversions (Exchanges)*, earlier.

Partially nontaxable exchange. If, in addition to like property, you receive money or unlike property in a like-kind exchange, you have a partially nontaxable exchange. You are taxed on the gain you realize, but only to the extent of the money and the fair market value of the unlike property you receive.

To figure the amount of taxable gain, first determine the fair market value of any unlike property you receive and add it to the amount of any money you receive. The total is the maximum amount of gain that can be taxed. Next, figure the amount of gain on the whole exchange, as discussed earlier under *Gain or Loss from Sales and Exchanges*. Your taxable gain is the lesser of these two amounts. A loss is never deductible in a nontaxable exchange, even though you receive unlike property or cash.

Example. You exchange real estate held for investment that has an adjusted basis of \$8,000 for other real estate that you want to hold for investment. The real estate you receive has a fair market value of \$10,000. You also receive \$1,000 in cash. Although the total gain realized on the transaction is \$3,000, only \$1,000 (cash) is recognized and included in your income.

Assumption of liabilities. If the other party to a nontaxable exchange assumes any of your liabilities, or you transfer property subject to a liability, you will be treated as if you received cash in the amount of the liability. If, in the previous example, the property you give up is subject to a \$3,000 mortgage, figure the gain realized and the amount of gain to be taxed as follows:

Fair market value of like property received	\$10,000
Cash	1,000
Mortgage assumed on property given up	3,000
Total received	\$14,000
Minus: Adjusted basis of property you transferred	8,000
Realized gain	\$ 6,000

The realized gain is taxed only up to \$4,000, the sum of the money (\$1,000) and the mortgage (\$3,000). For information on figuring the basis of the new property, see Publication 551.

If you pay money. If, in addition to giving up like property, you pay money in a like-kind exchange, you still have no taxable gain or deductible loss.

Example. Bill Smith trades an old cab for a new one. The new cab costs \$10,800. He is allowed \$2,000 for the old cab, and pays \$8,800 cash. He has no taxable gain or deductible loss on the transaction, regardless of the adjusted basis of his old cab. If Bill had sold the old cab to a third party for \$2,000 and purchased a new one, he would have had a recognized gain or loss on the sale of his old cab equal to the difference between the amount realized and the adjusted basis of the old cab.

If you give up unlike property. If, in addition to like property, you give up unlike property, you must recognize gain or loss only on the unlike property you give up. The gain or loss is equal to the difference between the fair market value of the unlike property and that property's adjusted basis.

Example. You exchange stock and real estate that you held for investment for real estate that you also intend to hold for investment. The stock you transfer has a fair market value of \$1,000 and an adjusted basis of \$4,000. The real estate you exchange has a fair market value of \$19,000 and an adjusted basis of \$15,000. The real estate you receive has a fair market value of \$20,000. You do not have a taxable gain or a deductible loss on the exchange of the real estate because it qualifies as

a nontaxable exchange. However, you must recognize (include in income) a \$3,000 loss on the stock because it is unlike property.

Sale and purchase. If you sell property and buy similar property in two mutually dependent transactions, you may be required to treat the sale and purchase as a single nontaxable exchange.

Example. You used your car in your business for 2 years. Its adjusted basis is \$3,500 and its trade-in value is \$4,500. You are interested in a new car that costs \$10,500. Ordinarily, you would trade your old car for the new one and pay the dealer \$6,000. Your basis for depreciation of the new car would then be \$9,500 (\$6,000 plus \$3,500 basis for the old car).

Because you want your new car to have a larger basis for depreciation, you arrange to sell your old car to the dealer for \$4,500. You then buy the new one for \$10,500 from the same dealer. However, you will be treated as having exchanged your old car for the new one because the sale and purchase are reciprocal and mutually dependent. Your basis for depreciation for the new car will be \$9,500, the same as it would have been if you had traded the old car.

Multiple-party transactions. The like-kind nontaxable exchange rules also apply to property exchanges that involve **three- and four-party transactions**. Any part of these multiple-party transactions can qualify as a nontaxable like-kind exchange if it meets all six of the conditions described earlier, including the identification and completed transaction requirements. Also, if the nontaxable exchange includes the receipt of money or unlike property (in addition to like property), any gain realized will be taxed to the extent of the money plus the fair market value of the unlike property.

Receipt of title from third party. If you received property in a like-kind exchange and the other party who transfers property to you does not give you the title but a third party does, you may still treat this transaction as a nontaxable exchange.

Partnership interests. The like-kind nontaxable exchange rules do not apply to any exchange of interests in different partnerships. The exchange of interests in the same partnership may qualify as a like-kind exchange. See *Sales, Exchanges, and Other Transfers* in Publication 541, *Tax Information on Partnerships*.

U.S. Treasury notes or bonds. Certain issues of U.S. Treasury obligations may be exchanged for certain other issues, designated by the Secretary of the Treasury, with no gain or loss recognized on the exchange. See *U.S. Treasury Bills, Notes, and Bonds under Interest Income* in Publication 550 for more information on income from these investments. For other information on the notes or bonds involved, write to the Bureau of the Public Debt, U.S. Treasury Department, Washington, DC 20239-1000.

Insurance policies and annuities. No gain or loss is recognized (included in income) if you exchange:

- 1) A life insurance contract for another or for an endowment or an annuity contract,
- 2) An endowment contract for an annuity contract or for another endowment contract providing for regular payments beginning at a date not later than the beginning date under the old contract, or
- 3) An annuity contract for another if the insured or annuitant remains the same. However, gain on the sale of an annuity contract before its maturity date attributable solely to interest accumulated on the contract is ordinary income.

If you realize a gain on the exchange of an endowment contract or annuity contract for a life insurance contract or an exchange of an annuity

contract for an endowment contract, you must recognize (include in income) the gain.

Reporting the exchange. Report the exchange of like-kind property on Schedule D (Form 1040) or on Form 4797, whichever applies. The instructions for each form explain how to report the details of the exchange. Report the exchange even though no gain or loss is recognized.

New Form 8824. Beginning in 1990, if you have a like-kind exchange, you must file Form 8824, *Like-kind Exchanges* in addition to Schedule D (Form 1040) or Form 4797.

Transfers Between Spouses

No gain or loss is recognized (included in income) on a transfer of property, from an individual to (or in trust for the benefit of) a spouse, or to a former spouse if incident to divorce. This rule does not apply if the recipient-spouse is a nonresident alien. It also does not apply to a transfer in trust if the adjusted basis of the property is less than the amount of the liabilities assumed and liabilities on the property.

For more information on transfers between spouses, see *No gain or loss under Property Settlements* in Publication 504, *Tax Information for Divorced or Separated Individuals*.

Exchanges of Corporate Stocks

In certain cases, exchanges of corporate stock are nontaxable. The rules for these exchanges are given below.

A corporation's own stock. A corporation may dispose of its own stock, including treasury stock, without having a taxable gain or loss.

Stock for stock of the same corporation. You may exchange common stock for common stock in the same corporation, or preferred stock for preferred stock in the same corporation, without having a taxable gain or loss.

Convertible stocks and bonds. If you convert bonds into stock, or preferred stock into common stock, you will not have a taxable gain or loss. For this rule to apply, the stock you receive must be in the same corporation as the bond or preferred stock you convert. The conversion must also be made according to the terms of the bond or preferred stock certificate.

Corporate reorganizations. When a corporation reorganizes, the exchange of securities in the old organization for securities in the new organization may be nontaxable.

Property for stock. If you transfer property to a corporation in exchange for stock or securities in that corporation, and immediately afterwards you are in control of the corporation, the exchange is usually nontaxable. This rule applies both to individual investors and to groups of investors who transfer property to a corporation.

However, if the property exchanged includes depreciable property, you may be taxed on ordinary gain because of depreciation. See Chapter 4 for more information on the disposition of depreciable property.

Control of a corporation. To be in control of a corporation, you or your group of investors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock.

Example 1. You and Bill Jones purchase property for \$100,000. Together, you organize a corporation at a time when the property has a fair market value of \$300,000. You transfer the property to the corporation for all of its authorized capital stock, which has a par value of \$300,000. No gain is included in income by you, Bill, or the corporation.

Example 2. You and Bill transfer the property having a basis of \$100,000 to a corporation in exchange for stock having a fair market value of \$300,000. This represents only 75% of each class of stock of the corporation. The other 25% already has been issued to someone else. You and Bill recognize a taxable gain of \$200,000 on the transaction.

Services rendered. The term *property* does not include services rendered or to be rendered to the issuing corporation. Therefore, stock received for services is income to the recipient.

Example. You transfer property worth \$35,000 and render services valued at \$3,000 to a corporation in exchange for stock valued at \$38,000. Right after the exchange you own 85% of the outstanding stock. No gain is included in income on the exchange of property; however, you will recognize ordinary income of \$3,000 as payment for the services you rendered to the corporation.

Property of relatively small value. The term *property* does not include property of a relatively small value when it is compared to the value of stock and securities already owned or to be received for services by the transferor, if the main purpose of the transfer is to qualify the nonrecognition of gain or loss by other transferors.

Property transferred will not be considered to be of relatively small value if its fair market value is at least 10% of the fair market value of the stock and securities already owned or to be received for services by such person.

Stock received in disproportion to property transferred. If a group of investors exchange property for corporate stock, each investor does not have to receive stock in proportion to his or her interest in the property transferred. If a disproportionate transfer takes place, it will be treated for tax purposes in accordance with its true nature. It may be treated as if the stock had been received in proportion first and then some of it was used to make gifts, pay compensation for services, or satisfy the transferor's obligations.

Money or other property. If, in an otherwise nontaxable exchange of property for corporate stock, you also receive money or property other than stock, you may have a taxable gain. You are taxed only up to the amount of money plus the fair market value of the other property you receive. The rules for figuring gain in this situation generally follow those for a *Partially nontaxable exchange* discussed earlier under *Like-Kind Exchanges*. No loss is recognized.

Liabilities. If the corporation assumes your liabilities, or the property is taken subject to a liability, the transfer generally will not be treated as if you received money or other property. There are two exceptions to this treatment:

- 1) If the liabilities the corporation assumes are more than your adjusted basis in the property you exchange, gain is recognized up to the amount of the excess. However, if the liabilities assumed would give rise to a deduction when paid, such as a trade account payable or interest, no gain is recognized.
- 2) If there is no good business reason for the corporation to assume your liabilities, or if your main purpose in the exchange is to avoid federal income tax, the assumption will be treated as if you received money in the amount of the liabilities.

Example. You transfer property to a corporation for stock. You also receive cash of \$10,000 in the exchange. Your adjusted basis in the property you transfer is \$20,000. The stock you receive has a fair market value of \$18,000. The corporation also assumes a mortgage of \$5,000 on the property. The gain realized is as follows:

Stock received, fair market value	\$16,000
Cash received	10,000
Liability assumed by corporation	5,000
Total received	\$31,000
Minus: Adjusted basis of property transferred	20,000
Realized gain	\$11,000

The recognized gain is limited to \$10,000, the amount of cash received.

Installment obligation exchanged for stock of the debtor. If an installment obligation is exchanged only for stock having a value that is more than the creditor's basis in the installment obligation, the exchange is a satisfaction of the installment obligation at other than its face value. Gain is recognized by the creditor on the exchange even though right after the exchange the former creditor is in *control* of the corporation. The difference between the fair market value of the stock and the creditor's basis in the installment obligation is the gain recognized on the exchange. The creditor's basis in the installment obligation is the excess of the face value of the obligation over the income returnable if the obligation were satisfied in full. The corporation does not recognize any gain or loss from the exchange.

For more information on corporations, see Publication 542, *Tax Information on Corporations*.

Conflict-of-Interest Rules

These rules apply to sales after November 30, 1989, to officers and employees of the executive branch of the federal government (and their spouses, or minors, or dependent children) who sell property under a certificate of divestiture. You can choose to recognize gain on the sale only to the extent the amount realized is more than the cost of permitted property you bought within 60 days of the sale.

Certificate of divestiture. A certificate of divestiture is any written decision that:

- 1) States you must divest yourself of certain property to comply with:
 - a) Federal conflict of interest rules, or
 - b) A request by a congressional committee,
- 2) Has been issued by the President or the Director of the Office of Government Ethics, and
- 3) Identifies the property to be divested.

Permitted property. Permitted property is any obligation of the U.S. or any diversified investment fund approved by regulations of the Office of Government Ethics.

Basis reduction of permitted property. If you do not recognize gain from the sale of the divested property you must reduce the basis of the permitted property by the amount of the non-recognized gain.

Chapter 2 Ordinary or Capital Gain or Loss

This chapter discusses ordinary gains and losses as well as capital gains and losses. Some of the areas included in this chapter are:

- Section 1231 property,
- Capital assets,
- Sales and exchanges between related parties,
- Foreclosures and repossessions, and
- Inventions, copyrights, and goodwill.

For tax years beginning after 1986, the 60% capital gains deduction is no longer allowed. The full

amount of the net capital gain is included in income. Also, net capital gains are taxed at the same rates as ordinary income.

You must still distinguish gains and losses as either ordinary or capital gains or losses and as either short-term or long-term gains or losses. These distinctions need to be made to arrive at your net capital gains or losses and for figuring the limit on capital losses. For information on how to treat your gains or losses, see Chapter 3, *Tax Treatment of Gains and Losses*, later.

Section 1231 property. Generally, this is property used in a trade or business or held for the production of rents or royalties and held more than one year. Gain on the sale of section 1231 property is a capital gain unless the gain is subject to the recapture rule. Loss on the sale of section 1231 property is an ordinary loss. Section 1231 property also includes any property (including capital assets held in connection with a trade or business) that is subject to an involuntary conversion. For more information, see *Section 1231 Property*, in chapter 4.

Capital Assets

For the most part, everything you own and use for personal purposes or investment is a capital asset.

Some examples of capital assets are:

- Stocks or bonds;
- A home owned and occupied by you and your family;
- Timber grown on your home property or investment property, even if casual sales of the timber are made;
- Household furnishings;
- A car used for pleasure or commuting;
- Coin or stamp collections;
- Gems and jewelry;
- Gold, silver, or any other metal.

Capital asset defined. Everything you own is a capital asset **except**:

- 1) **Property held mainly for sale to customers** or property that will physically become a part of the merchandise that is for sale to customers,
- 2) **Accounts or notes receivable** acquired in the ordinary course of a trade or business, or for services rendered as an employee, or from the sale of any of the properties described in (1),
- 3) **Depreciable property** used in your trade or business (even though fully depreciated),
- 4) **Real property** used in your trade or business,
- 5) **A copyright, literary, musical, or artistic composition, letter or memorandum, or similar property—**
 - a) Created by your personal efforts,
 - b) A letter, memorandum, or similar property prepared or produced for you, or
 - c) Acquired from a person who created the property, or for whom the property was prepared, under circumstances entitling you to the basis of the person who created the property, or for whom it was prepared or produced (for example, by gift), and
- 6) **U.S. Government publications** that you got from the government for free or for less than the normal sales price or that you acquired under circumstances entitling you to the basis of someone who got the publications for free or for less than normal sales price, if you sell, exchange, or contribute the publication.

Personal (nonbusiness) property. Property held for personal use is a capital asset. **Gain** from a sale or exchange of such property is a capital gain. A **loss** from the sale or exchange of such property is not deductible unless it results from a personal casualty loss.

Personal casualty gains and losses. To figure your personal casualty (or theft) loss, reduce each loss by \$100. If your personal casualty gains for the tax year exceed your personal casualty losses, all of your gains and losses are treated as sales and exchanges of capital assets. If your personal casualty losses for the tax year exceed your personal casualty gains, losses to the extent of gains can be deducted in full. Losses in excess of gains are deductible on Schedule A to the extent they exceed 10% of your adjusted gross income. Use Section A of Form 4684, *Casualties and Thefts*, to report all personal casualty gains and losses. For more information, get Publication 547, *Nonbusiness Disasters, Casualties, and Thefts*.

Investment property. Investment property is a capital asset and a gain or loss from its sale or exchange may be a capital gain or loss.

Nonbusiness bad debts. Nonbusiness bad debts except those evidenced by corporate securities are short-term capital losses.

Release of restriction on land. Amounts you get for the release of a restrictive covenant in a deed to land are treated as proceeds from the sale of a capital asset.

Noncapital Assets

This discussion illustrates some of the six exceptions to capital assets listed earlier.

Property held mainly for sale to customers. If you hold property mainly for sale to customers it is a noncapital asset. Whether property is held mainly for sale to customers in the ordinary course of business is a question of fact to be judged in each case. Among the factors to be considered are:

- 1) The purpose for which the property is acquired,
- 2) The development of the property between the time it was acquired and sold,
- 3) The number and frequency of sales, and
- 4) The time the property is held before it is sold.

Example 1. You are in the business of developing and selling restaurant businesses. You are constantly acquiring new sites, developing them and then selling the businesses. After you've completed construction of a restaurant and prior to its operation, you sell it. Because the businesses are property that you hold mainly for sale to customers in the ordinary course of your business, the businesses are not capital assets. Gain or loss from the sales of the businesses is ordinary gain or loss. The result would be the same if you had incorporated the restaurants and sold the stock of the corporations.

Example 2. You manufacture and sell steel cable which you deliver on returnable reels that are depreciable property. The customers make deposits on the reels, which you will refund if the reels are returned within a year. If they are not returned, you keep the deposits as the agreed-upon sales price. Most of the reels are returned within the one-year period. You keep adequate records showing depreciation and other charges to the capitalized cost of the reels. Under these conditions, the reels are not property held for sale to customers in the ordinary course of your business. Any gain or loss resulting from their not being returned may be capital or ordinary, depending on your section 1231 transactions.

Business assets. Business assets classified as real property or depreciable property used in your trade or business are not capital assets, but may be treated as such under certain circumstances (see *Section 1231 Property* in Chapter 4).

Rental property. Treat rental property as a business asset.

Sales and Exchanges Between Related Parties

Special rules apply to the sale or exchange of property between related parties. If these rules apply, gains may be treated as ordinary income and losses cannot be deducted.

Gain treated as ordinary income. If a gain is recognized on the sale or exchange of property, including a leasehold or a patent application that is depreciable property in the hands of the party who receives it, the gain may be ordinary income. The gain is ordinary income if the transaction is either directly or indirectly between:

- 1) A person and that person's controlled entity or entities (discussed below),
- 2) A taxpayer and any trust in which the taxpayer (or his or her spouse) is a beneficiary, unless the beneficiary's interest in the trust is a remote contingent interest, that is, the value of the interest computed actuarially is 5% or less of the value of the trust property,
- 3) An employer and any person related to the employer under rules (1) and (2), and
- 4) A welfare benefit fund (within the meaning of section 419(e)) that is controlled directly or indirectly by persons referred to in rule (3).

A controlled entity is:

- 1) A corporation in which **more than 50%** of the value of all outstanding stock, or a partnership in which **more than 50%** of the capital interest or profits interest is owned, directly or indirectly, by or for one person,
- 2) A corporation and a partnership, if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or profits interest, in the partnership,
- 3) Two corporations that are members of the same controlled group,
- 4) Two S corporations, if the same persons own more than 50% in value of the outstanding stock of each corporation,
- 5) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.

Determining control. For purposes of the above rules, use the following discussion to determine if you control an entity.

- 1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is treated as being owned proportionately by or for its shareholders, partners, or beneficiaries,
- 2) An individual is treated as owning the stock owned, directly or indirectly, by or for the individual's family, including only brothers and sisters (either whole or half), spouse, ancestors, and lineal descendants, or
- 3) Stock **constructively owned** by a person under rule (1), for applying rules (1) and (2), is treated as actually owned by that person. But stock constructively owned by an individual under rule (2) will not be treated as owned by the individual for applying rule (2) to make another person the constructive owner of that stock.

Loss not deductible. A loss on the sale or exchange of property is not deductible if the transaction is directly or indirectly between the following related parties:

- 1) Members of the same immediate family, including brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- 2) An individual and a corporation when the individual owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
- 3) Two corporations that are members of the same controlled group as defined in section 1563(a), except that "more than 50%" is substituted for "at least 80%" in that definition.
- 4) A trust fiduciary and a corporation when the trust or the grantor of the trust owns, directly or indirectly, more than 50% in value of the outstanding stock of the corporation.
- 5) A grantor and fiduciary, and the fiduciary and beneficiary, of any trust.
- 6) Fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- 7) A tax-exempt educational or charitable organization and a person who, directly or indirectly, controls such an organization, or a member of that person's family.
- 8) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership.
- 9) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 10) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.

If a sale or exchange is between any of these related parties and it involves the lump-sum sale of a number of blocks of stock or pieces of property, the gain or loss must be computed separately for each block of stock or piece of property. The gain on each item is taxable; however, the loss on any item is nondeductible. Also, gains from the sales of any of these items may not be reduced by losses on the sales of any of the other items.

Special rules for controlled groups. Losses on transactions between members of the same controlled group are deferred rather than denied.

For more information, see IRC 267(f).

Indirect transactions. Sales through a stock exchange may be subject to these rules: you may not deduct your loss on the sale of stock through your broker if, for example, under a prearranged plan a related person or entity buys the same stock that you had owned. These rules do not apply to a cross-trade between related parties through an exchange that is purely coincidental and in which there is no evidence of prearrangement.

Property received from a related party. If, in a sales or exchange, you receive property from a related party who had a loss on the exchange that was not allowable and you sell or exchange the property at a gain, you recognize the gain only to the extent that it is more than the loss previously disallowed to the transferor. This rule applies only to the original transferee.

Example 1. You sell stock with a cost basis of \$10,000 to your brother for \$7,600. Your loss of \$2,400 is not deductible. Later he sells the same stock to an unrelated party for \$10,500, thus realizing a gain of \$2,900 (\$10,500 - \$7,600). His

reportable gain is only \$500, the excess gain over the \$2,400 loss not allowed to you.

Example 2. Assume the same facts as in Example 1, except that your brother sells the stock for \$6,900 instead of \$10,500. His recognized loss is only \$700 (\$7,600 - \$6,900). He cannot deduct the loss that was not allowed to you.

Commonly controlled partnerships. No losses are allowed on the sale or exchange of property between partnerships that are commonly controlled. **Commonly controlled partnerships** are two partnerships in which one person directly or indirectly owns more than 50% of the capital interest or profits.

Ownership of stock. In determining whether an individual directly or indirectly owns any of the outstanding stock of a corporation for purposes of a loss on a sale or exchange, the following rules apply.

Rule 1. Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered to be owned proportionately by or for its shareholders, partners, or beneficiaries.

Rule 2. An individual is considered as owning the stock owned, directly or indirectly, by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

Rule 3. An individual owning (other than by applying rule 2) any stock in a corporation is considered to own the stock owned directly or indirectly by or for his or her partner.

Rule 4. For purposes of applying rules 1, 2, or 3, stock constructively owned by a person under rule 1 is treated as actually owned by that person. But stock constructively owned by an individual under rules 2 or 3 is not treated as owned by the individual for again applying either rule 2 or 3 to make another person the constructive owner of the stock.

Transferred patent. If you transfer a patent for value, see *Inventions*, as discussed later in this chapter, for transfers to certain related persons that will not qualify for capital gain treatment.

Cancellation or Sale of a Lease

Payments received by a tenant for the cancellation or sale of a lease may result in a gain or loss from the sale or exchange treated as a capital asset. If the lease was used in the tenant's trade or business, the gain or loss is a section 1231 gain or loss. If the lease was for the tenant's home, a gain would be taxed as a capital gain but any loss would not be deductible.

Payments received by a landlord. The payments received by a landlord (lessor) for the cancellation of a lease are ordinary income and not capital gains.

Cancelling a Sale of Real Property

If you sell real property under a sales contract that allows the buyer to return the property for a full refund and the buyer does so, you may not have to recognize gain or loss on the sale. If the buyer returns the property in the year of sale, no gain or loss is recognized. This cancellation of the sale in the same year it occurred places both you and the buyer in the same positions you were before the sale. If the buyer returns the property in a later tax year, however, you must recognize gain or loss in the year of the sale. When the property is returned in a later year, you acquire a new basis in the property. That basis is equal to the amount you pay to the buyer.

Foreclosure, Repossession, or Abandonment

If the owner (borrower) does not make payments due on a loan secured by property, the lender (mortgagee or creditor) may foreclose on the mortgage or repossess the property. The foreclosure or repossession is treated as a sale or exchange from which the owner may realize gain or loss (discussed below). This is true even if the property is voluntarily returned to the lender.

The owner who stops making payments on the secured loan may abandon the property. An abandonment is treated as a disposition from which the owner may realize ordinary income or loss (see *Income or loss on abandonment*, later).

If the owner is personally liable for repayment of the loan, then the foreclosure or repossession, or the abandonment of the property, may give rise to cancellation of debt income to the owner (see *Cancellation of debt and income or loss on abandonment*, later).

Further, if investment credit property is transferred or abandoned, the owner may owe additional tax from recapture of the investment credit. See Form 4255, *Recapture of Investment Credit*.

Gain or loss on foreclosure or repossession. The owner's gain or loss from the foreclosure or repossession described above is generally figured in the same way as a gain or loss from sales or exchanges. The gain or loss is the difference between the owner's adjusted basis of the property transferred and the amount realized. See *Gain or Loss from Sales or Exchanges* in Chapter 1, earlier.

Amount realized. If the owner is not personally liable for repayment of the debt secured by the property transferred, the amount realized by the owner includes the full amount of the debt cancelled by the transfer. The full amount of the cancelled debt is included even if the property's fair market value is less than the amount of the cancelled debt.

Example. In 1988, Chris purchased a new car for \$15,000. He paid \$2,000 down and borrowed the remaining \$13,000 from the dealer's credit company. Chris is not personally liable on the loan, but pledges the new car as security. In 1990, the credit company repossessed the car because Chris stopped making payments on the loan. The balance due was \$13,000. The car's fair market value when repossessed was \$9,000. The amount realized by Chris on the repossession is \$10,000. That amount is the debt cancelled by the repossession, even though Chris is not personally liable for the loan and the car's fair market value is less than \$10,000.

If the owner is personally liable for the debt, the amount realized on the foreclosure or repossession does not include amounts of the cancelled debts that are income to the owner from cancellation of debt. However, if the fair market value of the property transferred is less than the cancelled debt, the amount realized by the owner includes the cancelled debt up to the fair market value of the property. The owner is treated as receiving ordinary income from the cancelled debt for that part of the cancelled debt not included in the amount realized. See *Cancellation of debt*, later.

Example. Assume the same facts as in the previous example except that Chris is personally liable for the car loan. In this case, the amount realized by Chris is \$9,000, this is the amount of the cancelled debt (\$10,000) up to the car's fair market value (\$9,000). Also, Chris is treated as receiving ordinary income from cancellation of debt. That income is \$1,000 (\$10,000 - \$9,000), the part of the cancelled debt not included in the amount realized.

Capital or noncapital asset. If the property transferred is a capital asset, the owner's gain or loss is a capital gain or loss. If the property is not a capital asset, the gain or loss is an ordinary gain or loss, unless the property can be treated as a capital asset. See *Capital Assets and Noncapital Assets*, earlier.

Loss. A loss realized by the owner of property transferred through foreclosure or repossession is generally figured in the same way as a loss from sales or exchanges. See *Gain or Loss from Sales and Exchanges* in Chapter 1.

No deduction is allowed for a loss on:

- 1) A personal residence or other property held for personal use, unless the loss is from a personal casualty or theft (and the \$100 and 10% of AGI rules are met), or
- 2) The transfer of any property between related parties.

See *Capital Assets and Sales and Exchanges Between Related Parties*, earlier.

The owner will have a deductible loss if the adjusted basis of business or investment property transferred through foreclosure or repossession exceeds the amount realized (discussed earlier). Depending on whether the property is a capital asset, the loss may be an ordinary loss or a capital loss. See *Capital Assets and Noncapital Assets*, earlier. For information on the tax treatment of capital losses, see Chapter 3. For information on ordinary losses (normally from dispositions of section 1231 property), see Chapter 4 and Form 4797 in Chapter 5.

Example. In March 1989 Harold Woods purchased unimproved real property as an investment at a cost of \$77,000. He paid \$12,000 cash and obtained a \$65,000 note secured by a mortgage on the property. Harold repaid \$5,000 of the principal before he encountered financial difficulties. In May 1990 he defaulted on the note. At a foreclosure sale, the property was sold for \$60,000, the unpaid balance of Harold's mortgage loan. His loss on the transaction is \$17,000 (\$77,000 basis minus \$60,000 realized from the foreclosure and used to pay off the mortgage). Since Harold's foreclosed property was held for investment and is a capital asset held for more than one year, his loss is treated as a long-term capital loss.

Gain. If the amount realized by the owner of property transferred through foreclosure or repossession is greater than its adjusted basis, the excess is a gain, taxed in the same way as a gain from sales or exchanges generally. Gain from property held for personal use is taxed as a capital gain. Property used in a trade or business and held for more than one year is section 1231 property. Gain on sale or exchange of section 1231 property, whether by foreclosure or repossession, may qualify as long-term capital gain.

Example. John purchased property for \$34,000. He paid cash of \$7,500 and assumed a \$26,500 mortgage. During the year John had financial problems and the mortgage was subsequently foreclosed. The net proceeds from the foreclosure sale are \$35,000, representing an increase in the value of the property. Of this amount, John received \$8,500. His gain is \$1,000 (\$35,000 proceeds less \$34,000 basis).

Cancellation of debt. If property is transferred through foreclosure or repossession to satisfy a debt secured by the property, the owner may be treated as receiving ordinary income from cancellation of debt. However, the income may not be recognized in certain cases, such as a debt cancellation intended as a gift, an insolvent debtor, or bankruptcy. See *Cancellation or Forgiveness of Your Debt* in Publication 908.

Income from cancellation of debt is in addition to the gain or loss from the sale or exchange (transfer of property). This ordinary income from the cancellation of debt may arise if:

- 1) The owner is personally liable for repayment of the debt secured by the property transferred to satisfy the debt, and
- 2) The fair market value (FMV) of the property transferred is less than the amount of cancelled debt.

The amount realized by the owner from the transfer of property does not include the amount of cancelled debt that is more than the FMV of the property transferred. However, the owner may have ordinary income from cancellation of debt for that part of the cancelled debt not included in the amount realized.

Example. Frank is personally liable for repaying a mortgage on his investment property. After Frank stopped making payments on the mortgage, the lender foreclosed on it. The balance due was \$7,500. When the property was transferred to the lender, its FMV was \$6,000 and Frank's adjusted basis in it was \$8,000. Frank realized a capital loss of \$2,000 (\$8,000 basis minus \$6,000 amount realized) and ordinary income from discharge of indebtedness of \$1,500 (\$7,500 mortgage debt discharged minus \$6,000 FMV of property transferred to satisfy the debt).

Income or loss on abandonment. If the owner is personally liable for a debt secured by property that has been abandoned, and the debt is cancelled, the owner may be treated as receiving ordinary income from cancellation of debt to the extent of the unpaid debt. However, the income may not be recognized in certain cases, such as a debt cancellation intended as a gift, an insolvent debtor, or bankruptcy. See Publication 908.

Loss from abandonment of business or investment property is deductible as an ordinary loss up to the amount of the property's adjusted basis when abandoned. However, if the property is later foreclosed on or repossessioned, there may be gain or loss, figured as discussed earlier under *Gain or loss on foreclosure or repossession*. The abandonment loss is taken in the tax year in which the loss is sustained. The owner, however, may not deduct any loss on his or her personal residence or other property held for personal use, unless the loss is from personal casualty or theft.

Property transfer by insolvent taxpayer. If you are insolvent and transfer property that secures a debt to the lender to satisfy that debt, you must recognize any gain on the transfer. Recognize the gain to the extent the property's fair market value is more than its basis. If the amount of the debt is more than the fair market value of the property you transferred, the difference is generally taxable to you as cancellation-of-debt income. You can exclude from gross income, however, the cancellation-of-debt income up to the amount you are insolvent (excess of liabilities over assets).

Reporting income or loss. The owner of property transferred through foreclosure or repossession to satisfy a debt generally reports gain or loss on the transfer in the same way as for a gain or loss on sales or exchanges. See Chapter 5, *Reporting Gains and Losses*. If the owner who transfers or abandons property has taxable income from cancellation of debt, that income is reported on line 22 of Form 1040.

Abandonment loss. The owner who abandons business or investment property may have an ordinary loss up to the amount of the property's adjusted basis when abandoned. This loss is reported on Form 4797, Part II, line 10.

Form 1099-A. If you are the owner of property that is secured by a loan and the lender acquires an interest in it, the lender may send you a Form 1099-A, *Information Return for Acquisition or Abandonment of Secured Property*, or an equivalent statement. You may also get a Form 1099-A from the lender if you abandoned the secured property and the lender had reason to know that the property had been abandoned. The

lender must give you a copy of this form by January 31, 1991.

Form 1099-A gives the information needed to determine whether or not the owner has income or loss on the acquisition or abandonment of his or her property. If the owner believes any of the information on the form is inaccurate, he or she should contact the issuer of the form immediately. Otherwise, the owner should figure income or loss and report it as discussed in this publication.

Seller's (lender's) gain or loss on repossession. If you finance a buyer's purchase of property and later acquire an interest in the property through foreclosure or abandonment, you may have a gain or loss on the acquisition. For more information, see *Repossessions* in Publication 537, *Installment Sales*.

If you acquire an interest in property that was security for a loan, or know that the property was abandoned, you must file an information return with the Internal Revenue Service and report the information to the borrower. See Form 1099-A, above.

Sale of a Business

The sale of a business is not usually a sale of one asset.

Sole proprietorships. A sole proprietorship usually has many assets. When sold, these assets must be classified as capital assets, depreciable property used in the business, real property used in the business, or property held for sale to customers, such as inventory or stock in trade. The gain or loss on each asset is figured separately. The sale of capital assets results in capital gain or loss (discussed in Chapter 4); the sale of real property or depreciable property used in the business results in gain or loss from a section 1231 transaction; and the sale of inventory results in ordinary income or loss. See *Goodwill* for information on the allocation of the sales price when goodwill exists.

Partnerships. An interest in a partnership or joint venture is treated as a capital asset when sold. The part of any gain or loss that is from unrealized receivables or inventory items that have appreciated substantially in value will be treated as ordinary gain or loss. For more information on partnerships, see *Unrealized Receivables and Inventory Items* in Publication 541, *Tax Information on Partnerships*. Also see *Goodwill*, later.

Corporations. Your interest in a corporation is represented by stock certificates. When you sell the certificates, you usually realize capital gain or loss. For information on the sale of stock, see *Sales and Trades of Investment Property* in Publication 550, *Investment Income and Expenses*.

Corporate liquidations of property are generally treated as a sale or exchange. Gain or loss is generally recognized by the corporation on the liquidating sale of its assets. Gain or loss is also generally recognized on a liquidating distribution of assets as if the corporation had sold the assets to the distributee at fair market value.

Inventions

An invention is usually a capital asset in the hands of the inventor whether or not a *patent* or patent application was obtained. The inventor is the individual whose efforts created the property and who qualifies as the original and first inventor or joint inventor.

Transfer. If you transfer (sell or exchange) a patent you may be able to apply a special tax treatment (described later) to the transfer. To be eligible, all of the following must be met:

- 1) The transfer was other than a gift, inheritance, or device,

- 2) You acquire all substantial rights in the patent or an undivided interest in all such rights,
- 3) The patent is acquired before the invention it covers is tested and operated successfully under operating conditions,
- 4) It must not be transferred to or acquired from a related person (described later), and
- 5) It must not be acquired from your employee if he or she is the inventor under a contract requiring the transfer.

All **substantial rights** to patent property are all rights that are of value when they are transferred. The right to prohibit sublicensing or subassignment of rights, or the keeping of a security interest (such as a lien), or a reservation calling for forfeiture for nonperformance, are not treated as substantial rights for these rules and may be kept by you as the holder of the patent.

In the following situations, all substantial rights were not transferred, and the holder is not entitled to the special tax treatment described later:

- 1) The rights are limited geographically within a country (limiting the rights to one or more whole countries could be a transfer of all substantial rights).
- 2) The rights are limited to a period less than the remaining life of the patent.
- 3) The rights are limited to fields of use within trades or industries that are less than all the rights that exist and have value at the time of the grant.
- 4) The rights are less than all the claims or inventions covered by the patent that exist and have value at the time of the grant.

Special tax treatment. If you are the inventor or an individual who acquired all the substantial rights to the patent property and you transfer all the substantial rights or an undivided interest in all of these rights, the transfer will be treated as a sale or exchange of a long-term capital asset. This applies even if you have not held the patent property for more than one year and the payments received are made:

- 1) Periodically during the transferee's use of the property, or
- 2) Contingent on the productivity, use, or disposition of the transferee's rights in the property.

Related persons. The special tax treatment does not apply if the transfer is either directly or indirectly between you and a related person, as defined earlier under *Sales and Exchanges Between Related Parties*, and its discussion *Loss not deductible*, with the following changes:

- 1) Members of your immediate family include your spouse, ancestors, and lineal descendants, but not your brothers or sisters or half-brothers or half-sisters.
- 2) An individual and a corporation are considered related parties if the individual owns, directly or indirectly, 25% or more in value of the outstanding stock of the corporation.
- 3) A partnership and a partner, if the partner owns, directly or indirectly, more than 25% or more of the capital or profits of the partnership (other than an interest in the partnership).
- 4) Two partnerships, if the same persons, directly or indirectly, own more than 25% or more of the capital or profits of each.

If you come within the definition of a related taxpayer independent of family status, the brother-sister exception does not apply. Thus, a transfer between a brother and sister, one of whom is the beneficiary and the other the fiduciary of the same trust, is a transfer between related parties. The brother-sister exception does not apply because

the trust relationship is independent of family status.

Transfer of trade secrets. Trade secrets (technical "know-how") are generally eligible for capital gain treatment on their sale or exchange. A transfer of a trade secret is a sale or exchange, if the transfer includes all substantial rights to the trade secret. The substantial rights that must be transferred are the right to use the trade secret in perpetuity or until it becomes public knowledge and no longer protectable under the laws of the country where the transferee operates, and the exclusive right to prevent further disclosure.

Copyrights

Literary, musical, or artistic compositions, or similar property are not treated as capital assets if your personal efforts created them, or if you acquired the property in such a way that all or part of your basis in the property is determined by reference to a person whose personal efforts created it (for example, if you receive the property as a gift). The sale of such property, whether or not it is copyrighted, results in ordinary income and is generally reported on Form 4797, *Sales of Business Property*.

If you acquire such property or a copyright to it in any other way, the amounts you receive for granting the exclusive use or right to exploit the work throughout the life of the copyright are treated as being received from the sale of property. It does not matter if the payment is a fixed amount or a percentage of receipts from the sale, performance, exhibition, or publication of the copyrighted work, or an amount based on the number of copies sold, performances given, or exhibitions made. Nor does it matter if it is paid over the same period as that covering the grantee's use of the copyrighted work.

If the property is used in your trade or business, the gain or loss is a section 1231 gain or loss.

Letters, memorandums, etc. Letters, memorandums, and similar property (such as a draft of a speech, recordings, transcripts, manuscripts, drawings, or photographs) are not treated as capital assets if your personal efforts created them or if they were prepared or produced for you. Also, this property is not a capital asset if your basis in the property is determined by reference to the person who created the property or the person for whom it was prepared. For this purpose, letters and memorandums addressed to you are considered prepared for you. If letters or memorandums are prepared by persons under your administrative control, they are considered prepared for you whether or not you review them.

Goodwill

Goodwill is a capital asset that may or may not exist within a business. If it does exist, then when the business is sold, the seller can receive capital gain treatment on the part of the sales price that is for goodwill. The buyer cannot deduct any of the amount paid for goodwill because it is a capital asset with an unknown useful life and it cannot be depreciated or amortized. The amount the buyer pays for goodwill becomes its basis to the business.

Goodwill is also used to represent **going concern value** and includes every positive advantage that a firm gets in doing its business. It is the total of all those indefinable qualities that bring customers to a business, such as the right to have the business at a particular location under a trade name or trademark, any special knowledge or know-how, the number and quality of customers, or any other similar elements of value in the business as a going concern.

Allocation of consideration paid (sales price) for a business. The sale of a trade or business for a lump-sum is considered a sale of each individual asset rather than a single asset. Except for assets exchanged under the like-kind exchange rules, both the buyer and seller of a business must use the residual method (explained later) to allocate the sales price to the various business assets transferred. This method determines the gain or loss from the transfer of each asset and how much of the sales price is for goodwill. It also determines the buyer's basis in the business' assets.

Consideration. The buyer's consideration is the cost of the assets acquired, and the seller's consideration is the amount realized (money plus fair market value of property received) from the sale of assets.

The residual method must be used for any transfer of a group of assets that constitutes a trade or business and for which the buyer's basis is determined only by the amount paid for the assets. This applies to both direct and indirect transfers, such as the sale of a business, or the sale of a partnership interest in which the basis of the buyer's share of the partnership assets is adjusted for the amount paid. A group of assets constitutes a trade or business if goodwill could, under any circumstances, attach to the assets.

Residual method. The residual method provides for the consideration to be reduced first by the amount of cash, demand deposits, and similar accounts transferred by the seller. The amount of consideration remaining after this reduction must be allocated among the business' various assets in a specified order, and then the remainder of the sales price must be allocated to goodwill.

The allocation must be made among the following assets in proportion to (but not in excess of) their fair market value on the purchase date in the order specified.

- 1) Certificates of deposit, U.S. government securities, readily marketable stock or securities, and foreign currency.
- 2) All other assets, both tangible and intangible, except goodwill.

After making this allocation, the remainder of the sales price is allocated to goodwill.

Example. The total amount paid in the sale of Company SKB is \$21,000. No cash or demand deposits were sold. The company's U.S. government securities had a fair market value of \$3,200. Other business assets had a fair market value of \$15,000. Of the \$21,000 paid for Company SKB, \$3,200 is allocated to U.S. government securities, \$15,000 to other business assets, and the remaining \$2,800 to goodwill.

Reporting requirement. Both the buyer and the seller involved in the sale of business assets must report to the IRS the allocation of the sales price among goodwill and the other business assets. Form 8594, *Asset Acquisition Statement*, should be used to provide this information. The buyer and seller should each attach Form 8594 to their federal income tax returns for the year in which the sale occurred.

Agreement (covenant) not to compete accompanying sale of goodwill. When an agreement not to compete for a set number of years can be separated from goodwill, the agreement is not a capital asset. The amount received for it is ordinary income. However, if an agreement not to compete goes along with the transfer of goodwill in the sale of a going concern and assures the purchaser of the beneficial enjoyment of the goodwill acquired, the agreement may not be separated from goodwill and is a capital asset. You must establish from the facts and circumstances in your particular case whether you have sold goodwill or have entered into an agreement not to compete.

Professional skill or other characteristics of an owner. Whether the amount you got for the sale of a professional practice is for goodwill depends on the facts in each case. The dependence of the business solely on the professional skill or other personal characteristics of the owner is not the main factor.

If the seller keeps a right to fees collected after the sale for services performed before the sale, or gets a payment for giving up all or part of the right to these fees, the amount received is for services performed before the sale rather than from the sale of goodwill, and is ordinary income.

If the seller keeps a right to any fees or revenue collected for services performed after the sale, or if the buyer agrees to pay an amount equal to any part of these fees or revenue, these amounts are ordinary income from the business, and not amounts from the sale of goodwill.

Amounts received by a professional when admitting partners to his or her practice may be payment for a partial transfer of goodwill (rather than for an assignment of anticipated future earnings). In such a case, the goodwill must actually exist and the amount allocated to it must be a payment for it.

Transfer of a Franchise, Trademark, or Trade Name

A franchise includes an agreement that gives one of the parties the right to distribute, sell, or provide goods, services, or facilities within a specified area.

If the amounts you pay or incur to buy a franchise, trademark, or trade name are not contingent, and the transferor does not retain any significant power, right, or continuing interest, then your payments are for the purchase of a capital asset and must be capitalized.

The transfer of a franchise, trademark, or trade name will not receive capital gain or loss treatment if the transferor keeps any significant power, right, or continuing interest in the franchise, trademark, or trade name. A transfer includes the renewal of a franchise, trademark, or trade name.

A **significant power**, right, or continuing interest in a franchise, trademark, or trade name includes, but is not limited to, the following rights in the transferred interest:

- 1) A right to disapprove any assignment of the interest, or any part of it.
- 2) A right to end the agreement at will.
- 3) A right to set standards of quality for products used or sold, or for services provided, and for the equipment and facilities used to promote such products or services.
- 4) A right to make the recipient sell or advertise only the products or services of the transferor.
- 5) A right to make the recipient buy most supplies and equipment from the transferor.
- 6) A right to get payments based on the productivity, use, or disposition of the item of interest transferred if those payments are a substantial part of the transfer agreement.

Amounts you receive or accrue for a franchise, trademark, or tradename that are contingent on the productivity, use or disposition of these assets are not treated as amounts received from a sale of a capital asset.

Treatment of payments by transferee. If the transferor keeps any significant power, right, or continuing interest, then the payments are deductible as a business expense if they are part of a series of payments generally equal in amount and payable at least annually. Otherwise, they are deductible:

- 1) Over a 10-year period if the principal amount agreed upon is \$100,000 or less, or

- 2) Over the useful life of the franchise, trademark, trade name or a 25-year period (if the useful life cannot be determined).

For more information, see Chapter 13 in Publication 535.

Contingent payments. Amounts you pay or incur during the tax year to buy a franchise, trademark, or trade name that are contingent payments are deductible as business expenses. Contingent payments are payments that are based on the productivity, use, or disposition of the franchise, trademark, or trade name transferred.

Subdivision of Land

If you own a tract of land, and in order to sell or exchange it, you subdivide the land into individual lots or parcels, you may receive capital gains treatment on at least a part of the proceeds provided you meet certain requirements. See IRC section 1237.

Timber

If you sell standing timber you held as investment property, it is a capital asset and is treated as a sale of a capital asset. Gain or loss is reported on Schedule D (Form 1040). If you held the timber primarily for sale to customers, it is not a capital asset. Gain or loss on its sale is ordinary income or loss. It is reported in the gross receipts/sales and cost of goods sold items of your return. Special rules apply if you owned the timber more than one year and you choose either to:

- 1) Treat timber cutting as a sale or exchange, or
- 2) Enter into a cutting contract.

Under these rules, discussed below, disposition of the timber is treated as a sale or exchange of section 1231 property. Gain or loss is reported on Form 4797.

Usually, farmers who cut timber on their land and sell it as logs, firewood, or pulpwood have no cost or other basis for that timber. These sales constitute a very minor part of their farm business. In these cases, amounts realized from such sales, and the expenses of cutting, hauling, etc., may be entered as ordinary farm income and expenses on Schedule F.

Christmas trees. Evergreen trees, such as Christmas trees, that are more than 6 years old when severed from their roots and sold for ornamental purposes, are included in the term "timber." They qualify for both rules, discussed below.

Timber cutting as a sale or exchange. Under the general rule, the cutting of timber results in no gain or loss. It is not until the sale or exchange that gain or loss is realized. But if you owned, or had a contractual right to cut timber, you may choose to treat the cutting of timber as a sale or exchange in the year it is cut. Even though the cut timber is not actually sold or exchanged, you report your gain or loss on the cutting for the year the timber is cut. Any later sale results in ordinary income or loss (see *Example*, later).

Qualifying for treatment under this rule. To have your timber qualify for this treatment, you must:

- 1) Have owned, or held a contractual right to cut, the timber for a period of more than one year before the timber was cut,
- 2) Cut the timber for sale or for use in your trade or business, and
- 3) Elect to treat the cutting of the timber as a sale or exchange of property used in a trade or business (regardless of whether the timber is includible in inventory or held primarily for sale to customers).

Election. You make your election on your return for the year in which the cutting takes place by including in income the gain or loss on the cutting, and including a computation of your gain or loss. You do not have to make the election in the first year you cut timber. You may choose to make it in any year to which the election would apply. If the timber is partnership property, the election is made on the partnership return. This election cannot be made on an amended return.

Once you have made the election, it remains in effect for all later years, unless you revoke it. Except for the special rule noted below, you may revoke an election only if you can show undue hardship and get the consent of the Internal Revenue Service (IRS). Thereafter, you may not make any new election unless you have the consent of IRS.

Special revocation. A special rule for any election you made for a tax year beginning before 1987 allows you to revoke it for any tax year ending after 1986 without the consent of IRS. You can revoke the election by attaching a statement to the tax return for the tax year that the revocation is to be effective. If you make this special revocation, which can be made only once, you can make a new election without the consent of IRS. Any further revocation will require the consent of IRS.

The statement must provide:

- 1) Your name, address, and identification number,
- 2) That the revocation of election is being made to treat the cutting of timber as a sale or exchange under IRC section 631(a),
- 3) That the revocation is being made under section 311(d) of PL 99-514,
- 4) The year the revocation is effective and the timber to which applicable, and
- 5) That you are entitled to make revocation under section 311(d) of PL 99-514 and temporary regulations section 5(h).5(a)(3)(i).

Gain or loss. Your gain or loss on the cutting of standing timber is the difference between its adjusted basis for depletion and its fair market value on the first day of your tax year in which it is cut. The adjusted basis for depletion of cut timber is based upon the number of units (feet board measure, log scale, or other units) of timber cut during the tax year that are considered to be sold or exchanged. The adjusted basis for depletion is also based upon the depletion unit of timber in the timber account used for the timber cut, and should be figured in the same manner as shown in IRC 611 and regulations 1.611-3.

Depletion on timber is discussed in Publication 535, *Business Expenses*.

Example. In April 1990 you owned for more than 12 months 4,000 MBF (1,000 board feet) of standing timber. It has an adjusted basis for depletion of \$40 per MBF. You are a calendar year taxpayer. On January 1, 1990, the timber had a fair market value of \$120 per MBF. It was cut in April for sale. On your 1990 tax return, you elect to treat the cutting of the timber as a sale or exchange. You report as a gain the difference between the fair market value and your adjusted basis for depletion. This amount is reported on Form 4797, along with your other section 1231 gains and losses to figure whether it is treated as long-term capital gain or as an ordinary gain. You figure your gain as follows:

Fair market value of timber January 1, 1990 ..	\$480,000
Minus: Adjusted basis for depletion	160,000
Section 1231 gain	\$320,000

The fair market value would then become your basis of the cut timber, and a later sale of the cut timber, including any by-product or tree tops, would result in ordinary income or loss.

Cutting contract. If you own standing timber and dispose of it under a cutting contract, you must treat the disposal as a sale or exchange if you held the timber for more than one year before its disposal. You must also retain an economic interest in it.

The difference between the amount realized from the disposal of the timber and its adjusted basis for depletion is treated as gain or loss on its sale. Include this amount on Form 4797 along with your other section 1231 gains or losses to figure whether it is treated as capital or ordinary gain or loss.

Date of disposal. The date of disposal is the date the timber is cut. However, if you receive payment under the contract before the timber is cut, you may elect to treat the date of payment as the date of disposal. This election is effective only for the purpose of figuring the holding period of the timber. It has no effect on the time for reporting gain or loss. The election is made by a statement attached to the tax return filed by the due date (including extensions) for the year the payment is received. The statement shall identify the advance payments subject to the election and the contract under which they were made.

Owner. The owner is any person who owns an interest in timber, including a sublessor and the holder of a contract to cut timber.

Economic interest. An economic interest means that you have acquired an interest in standing timber by investment and get, by any form of legal relationship, income from cutting that timber, to get a return of your capital investment.

Example. You own standing timber that you held for more than one year. It has an adjusted basis for depletion of \$20 per MBF. You had no other gains or losses during the year. If you enter into a contract with a buyer that gives him a right to cut and remove the timber for \$40 per MBF, you will have a section 1231 gain of \$20 per MBF on its disposal.

Tree stumps. Tree stumps are a capital asset if they are on land held by an investor who is not in the timber or stump business as a buyer, seller, or processor. Gain from the sale of stumps sold in one lot by such a holder is taxed as a capital gain. However, tree stumps held by timber operators, after the saleable standing timber was cut and removed from the land are considered by-products. Gain from the sale of stumps by lot or on a tonnage basis by such operators is taxed as ordinary income.

Precious Metals and Stones, Stamps, and Coins

Gold, silver, stamps, coins, gems, etc., are capital assets except when they are held for sale by a dealer. Any gain or loss you have from their sale or exchange is generally a capital gain or loss. If you are a dealer, the amount received from the sale is ordinary income reportable on Schedule C (Form 1040).

Coal and Iron Ore

If you own coal (including lignite) or iron ore mined in the United States, for more than one year and dispose of it under a contract in which you keep an economic interest in the coal or iron ore, figure any resulting gain as follows. Take the difference between the amount realized from disposal of the coal or iron ore and the adjusted basis you use to figure depletion (increased by certain expenditures not allowed as deductions for the tax year). This amount is included on Form 4797 along with your other section 1231 gains and losses.

You are considered an **owner** if you own or sublet an economic interest in the coal or iron ore in place. If the tax on any capital gains from the

disposition of the coal or iron ore is less than the maximum rate for ordinary income, you are not entitled to the allowance for percentage depletion for the coal or iron ore. If you own only an option to buy the coal in place, you do not qualify as an owner. In addition, this special gain or loss treatment does not apply to income realized by an owner who is a co-adventurer, partner, or principal in the mining of coal or iron ore.

The expenses of making and administering the contract under which the coal or iron ore was disposed and the expenses of preserving the economic interest kept under the contract are not allowed as deductions in figuring taxable income. Rather, their total along with the adjusted basis is deducted from the amount received to determine the gain. If the total of the expense of making and administering the contract plus the adjusted depletion basis is more than the amount received, the result is a loss. The date of disposal is treated as the date the coal or iron ore is mined.

Special rule. The above treatment does not apply if you dispose of the iron ore or coal directly or indirectly to:

- 1) A related taxpayer (see *Loss not deductible, under Sales and Exchanges Between Related Parties*, earlier in this chapter), whose relationship to you would result in the disallowance of a loss,
- 2) A partnership if you are a partner who owns directly or indirectly more than 50% of the capital or profit interests in the partnership or between two partnerships in which the same persons own, directly or indirectly, more than 50% of the capital or profit interests, or
- 3) An individual, trust, estate, partnership, association, company, or corporation owned or controlled directly or indirectly by the same interests that own or control your business.

Chapter 3 Tax Treatment of Capital Gains and Losses

This chapter discusses the way capital gains are treated for tax purposes and how capital losses are deducted. It also includes information on how to figure capital gains and losses.

Long- and Short-Term

The treatment of capital gains and losses depends on how long you own the asset before you sell or exchange it. The time you own an asset before disposing of it is the holding period.

If you hold a capital asset one year or less, the gain or loss from its disposition is short term. If you hold a capital asset longer than one year, the gain or loss from its disposition is long term.

These distinctions are essential to correctly arrive at your net capital gain or loss. Capital losses are allowed in full against capital gains plus up to \$3,000 of ordinary income.

Inventions. Any gain or loss from the disposition of your own invention is generally long term, no matter how long you actually owned it. See *Inventions* in Chapter 2.

Inherited property. If you inherit property, your basis in that property is generally its fair market value at the date of the decedent's death or the later alternate valuation date if the estate qualifies and elects to use the alternate valuation. If no federal estate tax return was filed, use the appraised value (fair market value) at the date of death for

state inheritance or transmission taxes. You cannot use an alternate valuation date.

Gifts to decedent. The basis in certain appreciated property that you acquire may be the decedent's adjusted basis in the property immediately before death rather than its fair market value. This applies only if you or your spouse had given the appreciated property as a gift to the decedent during the one-year period ending on the date of death and the date of death was after 1981. Appreciated property is any property whose fair market value on the day it was given to the decedent is more than its adjusted basis.

Long-term gain or loss. If you inherit property and your basis for it is determined under one of the valuation methods just described, your **gain or loss on any later disposition** of the property is treated as a long-term capital gain or loss. You are considered to have held the property for more than one year even if you dispose of it within one year after the decedent's death.

Holding period. To figure if you held property more than one year, start counting on the day following the day you acquired the property. The same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. The day you dispose of the property is part of your holding period.

Example. If you bought an asset on June 19, 1990, you should start counting on June 20, 1990. If you sell the asset on June 19, 1991, your holding period is not more than one year, but if you sell it on June 20, 1991, your holding period is more than one year.

Installment sale. The gain from an installment sale of an asset qualifying for long-term capital gain treatment in the year of sale will continue to be long term in later tax years. If it is short term in the year of the sale it will continue to be short term when payments are received in later tax years.

Nontaxable exchanges. If you acquire an asset in exchange for another asset and your basis for the new asset is figured, in whole or in part, by your basis in the old property, the holding period of the new property includes the holding period of the old property. That is, it begins on the same day as your holding period for the old property.

Example. You bought machinery on December 1, 1989. On June 1, 1990, you traded this machinery for some other machinery in a nontaxable exchange. You sold the machinery you got in the exchange on December 3, 1990. The holding period is one year and a day.

Corporate liquidation. The holding period for property you receive in a liquidation generally starts on the day after you receive it if gain or loss is recognized. However, in a one-calendar-month liquidation in which your basis in the property is figured in whole or in part using the basis of the stock you gave up in the transaction, the holding period of the property includes the holding period of the stock.

Profit-sharing plan. The holding period of common stock withdrawn from a qualified contributory profit-sharing plan begins on the day following the day the plan trustee delivered the stock to the transfer agent with instructions to reissue the stock in the taxpayer's name.

Gifts. If you receive a gift of property and your basis in it is figured using the donor's basis, your holding period includes the donor's holding period. See *Property Received as a Gift* in Publication 551.

Real property. To figure how long you have held real property, start counting on the day after you received title to it or, if earlier, the day after you took possession of it and assumed the burdens and privileges of ownership.

However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Repossession. If you sell real property but keep a security interest in it and then later repossess it, your holding period for a later sale includes the period you held the property before the original sale, as well as the period after the repossession. Your holding period does not include the time between the original sale and the repossession. That is, it does not include the period during which the first buyer held the property.

Net Gain or Loss

The totals for short-term capital gains and losses and the totals for long-term capital gains and losses must be figured separately.

Net short-term capital gain or loss. Merge your short-term capital gains and losses. Do this by adding all your short-term capital gains. Then add all your short-term capital losses. Subtract one total from the other. The result is your net short-term capital gain or loss.

Net long-term capital gain or loss. Follow the same steps to merge your long-term capital gains and losses. The result is your net long-term capital gain or loss.

Net capital gain or loss. To figure your total net capital gain or loss, merge your net short-term capital gain or loss with your net long-term capital gain or loss.

Example. During the 1990 tax year, you have the following transactions:

Long-term capital gains	\$ 5,400	
Long-term capital losses	(1,750)	
Net long-term capital gain		\$ 3,650
Short-term capital gains	\$ 2,600	
Short-term capital losses	(3,790)	
Net short-term capital loss		(1,190)
Net capital gain		\$ 2,460

Total net capital gain. If you have a total net capital gain, the gain is taxable.

Total net capital loss. If you have a total net capital loss, the loss is deductible. But there are limits on how much of the loss you may deduct, and when you may deduct it. See *Treatment of Capital Losses*, next.

Treatment of Capital Losses

This discussion relates only to individuals who have allowable capital losses (see Chapter 2). For information on capital losses of corporations, see Publication 542.

If you have a net capital loss, you must deduct it even if you do not have ordinary income to offset the loss. The yearly limit on the amount of the capital loss you are required to deduct is the lower of:

- \$3,000 (\$1,500 if you are married and file a separate return), or
- Your net capital loss on line 18 of Schedule D (Form 1040).

Capital loss carryover. If your net capital loss is more than the yearly limit on capital loss deductions, carry over the excess to later years until it is completely used up. When you carry over a loss, it retains its original character as either long term or short term. A short-term loss that you carry over to

the next tax year is added to short-term losses that occur in that year. A long-term loss that you carry over to the next tax year is added to long-term losses that occur in that year. Thus, a long-term capital loss you carry over to the next year will reduce long-term gains of that year before it reduces short-term gains of that year.

You carry over the amount of a net capital loss that is more than the yearly limit on capital loss deductions to the next year and treat the carryover loss as if you had incurred it in that year. When you figure the amount of any capital loss carryover in a later tax year, exclude any capital losses allowable as a deduction in earlier years, even if you did not actually deduct the losses.

Example. Bob and Gloria Sampson sold property in 1990. The sale resulted in a capital loss of \$7,000. The Sampsons had no other capital transactions. On their joint 1990 return, the Sampsons deduct \$3,000, the lower of \$3,000 or \$7,000. The unused part of the loss, \$4,000 (\$7,000 - \$3,000), is carried over to 1991. The allowable \$3,000 deduction is considered used in 1990.

If the Sampsons' capital loss had been \$2,000, their capital loss deduction would have been \$2,000, the lower of \$3,000 or \$2,000. They would have no carryover to 1991.

If you have both short-term and long-term losses, your short-term losses are used first against your allowable capital loss deduction. If, after using the short-term loss, you have not reached the limit on the capital loss deduction, use the long-term losses until you reach your limit. This computation of your short-term capital loss carryover or your long-term capital loss carryover is made on Part IV of Schedule D (Form 1040).

Figuring your capital loss carryover. Complete Part IV of Schedule D (Form 1040) to determine the part of your capital loss for 1990 that you can carry over to 1991.

Joint and separate returns. On a joint return, the capital gains and losses of a husband and wife are figured as though they are the gains and losses of an individual. If you are married and filing a separate return, your yearly capital loss deduction is limited to \$1,500 (one-half of the \$3,000 limit allowed on a joint return). Neither you nor your spouse may deduct any part of the other's loss.

If you and your spouse once filed separate returns and are now filing a joint return, you and your spouse must combine each of your capital loss carryovers. However, if you and your spouse once filed jointly and are now filing separately, any capital loss carryover can be deducted only on the return of the person who actually had the loss.

Death of taxpayer. Capital losses cannot be carried over after a taxpayer's death. They are deductible only on the final income tax return filed on the decedent's behalf. The capital loss limits discussed earlier still apply in this situation. Even if the loss is greater than the limit, the excess cannot be deducted by the decedent's estate or carried over to following years.

Corporations. A corporation, other than an S corporation, may deduct capital losses only up to the amount of its capital gains. In other words, if a corporation has a total net capital loss, the loss cannot be deducted in the current tax year. It must be carried to other tax years and deducted from capital gains that occur in those years. For more information see Publication 542.

Chapter 4 Dispositions of Depreciable Property

If you dispose of depreciable property at a gain, you may have to treat all or part of the gain as ordinary income. This chapter discusses the rules for figuring the amount of gain on depreciable property that is ordinary income. (Losses are not subject to the rules discussed in this chapter.) It also includes information on section 1231 property, depreciation recapture, like-kind exchanges, and involuntary conversions.

Records. You must keep permanent records of the facts necessary to figure the amount of depreciation allowed or allowable on your depreciable property to figure any gain that must be reported as ordinary income. This includes the date and manner of acquisition, cost or other basis, depreciation, and all other adjustments that affect basis.

On property that you got in a nontaxable exchange or as a gift your records must also indicate the following:

- 1) Whether the adjusted basis was figured using depreciation or amortization you claimed on other property, and
- 2) Whether the adjusted basis was figured using depreciation or amortization another person claimed.

Property used in your business. Property used in your trade or business includes real property and depreciable personal property. It does not include property you hold for sale to customers.

Depreciable property. Depreciable property used to carry on your trade or business includes most assets for which you expect to get back nearly all of the item's cost through depreciation deductions.

Property for sale to customers. Property that is mainly for sale to customers or property that is includible in your inventory is not depreciable property. If you believe that you will get back all, or nearly all, of your investment in it, by selling it rather than by using it up in your business, it is property that is mainly for sale to customers. Thus, all cars acquired by a car dealer are treated as a part of the dealer's stock in trade unless the dealer can clearly show that a vehicle was bought only for use in the dealer's business (other than as a demonstrator), and it is believed that its cost will be recovered through depreciation rather than resale.

Example. A car dealer operates a car rental service as a part of the business. A car may be rented from 6 months to 2 years, with the renter having the option to buy it at any time. If the renter does not buy it before the end of the rental period, the auto is turned over to the used car division of the car dealer's business and sold. Such cars are not property used in a trade or business, but are held mainly for sale to customers. Gain on these sales must be reported as ordinary income.

Section 1231 Property

Property used in a trade or business or held for the production of rents or royalties and held more than one year is section 1231 property and is subject to section 1231 treatment. These rules also apply to other property that is subjected to an involuntary conversion. In a disposition of depreciable property, any ordinary gain that is from the deduction of depreciation is figured first by using the rules discussed later under *Depreciation Recapture on Personal Property or Depreciation*

Recapture on Real Property. Any remaining gain is included in the section 1231 computation in Part I of Form 4797.

Sales or exchanges of the following types of property may result in gain or loss subject to section 1231 treatment—

Real property or depreciable personal property. This property must be used in a trade or business and held for more than one year in order to qualify as section 1231 property.

Property held for the production of rents or royalties. This kind of property qualifies as section 1231 property if it is held for more than 1 year.

Leaseholds. Leaseholds must be used in a trade or business and held for more than one year in order to qualify as section 1231 property.

Cattle and horses. Cattle and horses held for draft, breeding, dairy, or sporting purposes and held for 2 years or more from acquisition date are section 1231 property.

Livestock. Livestock (other than cattle, horses, and poultry) held for draft, breeding, dairy, or sporting purposes and held 1 year or more from acquisition date is section 1231 property.

Unharvested crops. The sale, exchange, or involuntary conversion of an unharvested crop on land used in farming if the crop and land are sold, exchanged, or involuntarily converted at the same time and to the same person. The land must have also been held for more than one year to be section 1231 property.

Growing crops sold with a lease on the land, even though to the same person in the same transaction, are not included. Nor is a sale, exchange, or involuntary conversion of an unharvested crop with land included if the taxpayer keeps any right or option to reacquire the land, directly or indirectly (other than a right customarily incident to a mortgage or other security transaction).

Dispositions that may result in gain or loss subject to section 1231 treatment—

Timber, coal, and iron ore. The gain or loss from the cutting of timber and the disposal of timber, coal, or domestic iron ore with a retained economic interest as described, under *Timber and Coal*, and *Iron Ore* should receive section 1231 treatment.

Condemnations. The gain or loss on condemnations (property condemned for public use), if the property was held for more than 1 year should be treated as section 1231 gain or loss. This includes business property, and capital assets held in connection with a trade or business or a transaction entered into for profit, such as investment property. However, because losses from the condemnation of property held for personal use are not deductible, they are not included.

Casualty and theft gains and losses. For casualty and theft gains and losses to receive section 1231 treatment the property must be held for more than one year. These include casualty or theft to business property, property held for the production of rents and royalties, and investment property (such as notes and bonds). Insurance payments or other reimbursement must be taken into account in arriving at the net gain or loss. However, if your net losses from casualty or theft exceed gains from casualty or theft, they are not taken into account in the section 1231 computation.

For more information on casualties and thefts, see Publication 547, *Nonbusiness Disasters, Casualties, and Thefts*.

Treatment of Gains and Losses

Combine all gains and losses from the sales and dispositions of section 1231 property for the tax year. If your section 1231 gains exceed your section 1231 losses, you have a net section 1231 gain. If the section 1231 gains are more than the

section 1231 losses, then these gains and losses shall be treated as long-term capital gains or long-term capital losses. An excess of section 1231 losses over section 1231 gains results in a net section 1231 loss. If the section 1231 losses equal or exceed the section 1231 gains, then you treat each item as an ordinary gain or loss.

Recapture of net ordinary losses. A net section 1231 gain is treated as ordinary income to the extent the gain does not exceed nonrecaptured net section 1231 losses taken in prior years. **Nonrecaptured losses** are net section 1231 losses deducted for your five most recent tax years that have not yet been applied (recaptured) against any net section 1231 gains in a tax year beginning after 1984. Your losses are recaptured beginning with the earliest year subject to recapture.

Example. Ashley, Inc., a graphic arts company, is a calendar year corporation. In 1987 Ashley had a net section 1231 loss of \$8,000. For tax years 1989 and 1990, the company has net section 1231 gains of \$5,250 and \$4,600, respectively. In figuring taxable income for 1989, Ashley treated its net section 1231 gain of \$5,250 as ordinary income by recapturing \$5,250 of their \$8,000 net section 1231 loss. Then in 1990, Ashley applies the remaining net section 1231 loss, \$2,750 (\$8,000 minus \$5,250) against its net section 1231 gain of \$4,600. For 1990 the company reports \$2,750 as ordinary income and also reports \$1,850 (\$4,600 minus \$2,750) as long-term capital gain.

Casualty and thefts. If your recognized losses from involuntary conversions arising from fire, storm, shipwreck, other casualty, or theft exceed your recognized gains from such conversions, they are not included in figuring your net section 1231 gains or losses to figure recapture of net section 1231 losses.

Long-term capital gain or ordinary income? If you did not have any prior year net section 1231 losses or they were recaptured in an earlier year, treat your net section 1231 gain for 1990 as long-term capital gain.

If you had such losses and they were not recaptured, your net section 1231 gain is treated as ordinary income up to the amount of your nonrecaptured losses. If the gain exceeds your losses, the excess is a long-term capital gain.

Net section 1231 loss. A net section 1231 loss for 1990 is treated as an ordinary loss.

Depreciation Recapture on Personal Property

A gain on the disposition of section 1245 property is treated as ordinary income to the extent of depreciation allowed or allowable on the property. See *Treatment of Gain*, later.

Section 1245 property. This includes any property that is or has been subject to an allowance for depreciation and that is:

- 1) Personal property (both tangible and intangible),
- 2) An elevator or an escalator (placed in service before 1987),
- 3) Real property (not included in (4)) to the extent its adjusted basis has been reduced by certain amortization deductions including those for certified pollution control facilities, on-the-job training and child-care facilities, removal of architectural barriers to the handicapped and elderly, reforestation expenditures, or real property for which a section 179 deduction was taken, or
- 4) A special purpose structure or storage facility. This includes single-purpose agricultural and horticultural structures and storage facilities used in connection with the distribution of

petroleum or any primary product of petroleum. It is also any other depreciable tangible property, **except** a building or its structural components, that is or has been an integral part of certain business activities, a research facility used in connection with these activities, or a storage facility used in connection with these activities. These activities are manufacturing, production, extraction, or the furnishing of transportation, communications, electrical energy, gas, water, or sewage disposal services.

Buildings and structural components. Do **not** include a structure that is essentially an item of machinery or equipment as buildings and structural components. Also, do not include as a building a structure that houses property used as an integral part of an activity, if the use of the structure is so closely related to the use of the property that the structure clearly can be expected to be replaced when the property it initially houses is replaced. The fact that the structure is specially designed to withstand the stress and other demands of the property and the fact that the structure cannot be used economically for other purposes indicate that it is closely related to the use of the property it housed. Thus, structures such as oil and gas storage tanks, grain storage bins, silos, fractionating towers, blast furnaces, basic oxygen furnaces, coke ovens, brick kilns, and coal tipples are not treated as buildings.

A storage facility. This is a facility used mainly for the bulk storage of fungible commodities. To be fungible, a commodity must be such that one part may be used in place of another. Bulk storage means the storage of a commodity in a large mass before it is used. Stored materials that vary in composition, size, and weight are not fungible. One part cannot be used in place of another part and the materials cannot be estimated and replaced by simple reference to weight, measure, and number. Thus, if a facility is used to store oranges that have been sorted and boxed, it is not used for bulk storage. The storage of different grades and forms of aluminum scrap is not bulk storage of fungible commodities.

Treatment of Gain

The amount of gain treated as ordinary income on the sale, exchange, or involuntary conversion of section 1245 property, including a sale and lease-back transaction, is limited to the **lower** of the amounts listed below.

- 1) The recomputed basis of the property minus the adjusted basis of the property, or
- 2) The amount realized from the sale minus the adjusted basis of the property.

For any other disposition of section 1245 property, ordinary income is measured by the amount the fair market value exceeds the adjusted basis of the property. See *Other Dispositions*, later.

Recomputed basis. Recomputed basis of your section 1245 property is the total of its adjusted basis plus depreciation and amortization (allowed or allowable) included in the adjusted basis. This includes depreciation and amortization adjustments on:

- Property you exchanged for, or converted to, the present property in a like-kind exchange or involuntary conversion,
- Property owned by someone before you, and
- Property you presently own.

Figure the recomputed basis of section 1245 property as follows: take the property's adjusted basis and add back all depreciation or amortization (whether for the same or other property) that was allowed or allowable to arrive at the adjusted basis.

Example. In January 1988, Don Smith bought for \$10,000 and placed in service section 1245 property with a 5-year life. By the end of 1990, using the MACRS method, Don has deducted \$7,120 of depreciation which has reduced the asset's adjusted basis to \$2,880. Since this adjusted basis reflects deductions for depreciation of \$7,120, the recomputed basis of the property is \$10,000.

Property recovered in an exchange or conversion.

If you received property in a like-kind exchange or involuntary conversion, the recomputed basis of that property includes a depreciation or amortization adjustment taken on the old property you exchanged or converted. This adjustment is reduced by any gain you recognized on the exchange or conversion of the old property.

Property received as a gift. If you receive property as a gift, the recomputed basis is the basis of the gift to you (the adjusted basis in the hands of the donor) plus any depreciation adjustments of the donor for that property.

Depreciation. Depreciation is the amount allowed or allowable for section 1245 property for cost recovery of property used in a trade or business or held for the production of income.

Amortization. Amortization includes the section 179 deduction claimed (discussed later), and the deductions for: removal of certain barriers for the handicapped and elderly, child-care facilities or on-the-job training facilities, pollution control facilities, reforestation expenditures, and certain expenditures for certified historic structures.

Investment credit. In figuring the deductions affecting the recomputed basis of section 1245 property, you should also include any basis adjustment that was made for investment credit claimed on the property. See *Investment credit*, later.

Example 1. In February 1988 you purchased and placed in service for 100% use in your business a light-duty truck (5-year property) with an adjusted basis of \$10,000. You file your return on a calendar year. Your MACRS deductions for this truck were \$2,000 in 1988 and \$3,200 in 1989. You did not take the section 179 deduction on the truck. The MACRS deduction in 1990, the year of sale, is \$960 (1/2 of \$1,920). You sell the truck in May 1990 for \$7,000. Your adjusted basis is \$3,840 (\$10,000 minus \$6,160). Your recomputed basis is \$10,000 (\$3,840 plus \$6,160). The amount you treat as ordinary income is the lower of the following:

- 1) Recomputed basis (\$10,000) minus adjusted basis (\$3,840) or \$6,160, or
- 2) Amount realized (\$7,000) minus adjusted basis (\$3,840) or \$3,160.

The lower of these two amounts, \$3,160, is the amount of gain treated as ordinary income. You figure this amount on Form 4797.

Example 2. On January 2, 1981, you bought a machine for \$9,000. You claimed \$600 depreciation on it each year and sold it for \$8,000 on July 3, 1990. Your adjusted basis on the date of sale was \$3,300 (\$9,000 less \$5,700 (the \$600 depreciation for each of the years 1981 through 1989 and \$300 for 1990)). Your recomputed basis is \$9,000 (your total depreciation deductions plus your adjusted basis). The amount you treat as ordinary income is the lower of the following:

- 1) Recomputed basis (\$9,000) minus adjusted basis (\$3,300) or \$5,700, or
- 2) Amount realized (\$8,000) minus adjusted basis (\$3,300) or \$4,700.

The lower of these two amounts, \$4,700, is the amount of gain treated as ordinary income. Because the gain (\$4,700) is less than the total depreciation (\$5,700), the entire gain is included as ordinary income.

Section 1231 gain. Any gain that is more than the ordinary income part is a section 1231 gain. As such, it is subject to the rule on nonrecaptured net section 1231 losses for determining whether all or part of the section 1231 gain is treated as long-term capital gain or ordinary income. See *Treatment of Gains and Losses under Section 1231 Property*, earlier.

Depreciation on property other than personal property. You must take into account depreciation during periods when the property was not used as an integral part of an activity or did not constitute a research or storage facility, as described earlier.

For example, if depreciation deductions taken on certain storage facilities amounted to \$10,000, of which \$6,000 is from the periods before their use in connection with a prescribed business activity, you must use the entire \$10,000 in determining ordinary income because of depreciation.

Depreciation allowed or allowable. The greater of the depreciation allowed or allowable is generally the amount to use in figuring the part of gain to report as ordinary income. If in prior years you have consistently taken proper deductions under one method, the amount allowed for your prior years will not be increased even though a greater amount would have been allowed under another proper method. If you did not take any deduction at all for depreciation, your adjustments to basis for depreciation allowable are figured by using the straight line method of depreciation.

This treatment applies only when figuring what part of gain is treated as ordinary income under the rules for section 1245 depreciation recapture.

Class Life Asset Depreciation Range (CLADR) system. For treatment of gains for property depreciated under the CLADR system, including gains recognized in ordinary retirements and extraordinary retirements, see section 1.167(a)-11 of the Income Tax Regulations.

Section 179 deduction. Amounts deducted under the section 179 deduction are recovered as ordinary income to the extent of any gain on a sale or disposition. The section 179 deduction is treated as a deduction for depreciation and is included in the recomputed basis. See *Depreciation Recapture* in Publication 534, *Depreciation*.

Investment credit. On a disposition of section 1245 property or section 1250 property (discussed later), any reduction in basis by part or all of the investment credit claimed on the property is considered a deduction allowed for depreciation.

If a disposition results in the recapture of investment credit on property whose depreciable basis has been reduced, the basis of the property immediately before the disposition resulting in the recapture is increased by part or all of the recapture amount. This amount is any increase in tax that must be paid plus any adjustment to investment credit carrybacks or carryforwards.

Section 1245 property and other property in same disposition. A sale or other disposition may involve a combination of section 1245 property and other property. To figure the gain or loss on each item, the total amount realized must be allocated among the section 1245 property and the other property in proportion to each item's fair market value. If a buyer and seller have adverse interests, their arm's length agreement setting values for the items will establish the allocation. Special allocation rules apply to the sale of a group of assets that can be a trade or business. See *Allocating the Basis* in Publication 551, *Basis of Assets*. Losses cannot be used to offset gains to report a combined gain or loss for section 1245 property.

Multiple asset accounts. In figuring ordinary income because of depreciation, you may treat any number of units of section 1245 property in a single depreciation account as one item if the total ordinary income because of depreciation figured

by using this method is not less than it would be if depreciation on each unit were figured separately.

Example. In one transaction you sold 50 machines, 25 trucks, and certain other property that is not section 1245 property. All of the depreciation was recorded in a single depreciation account. After dividing the total received among the various assets sold, you figured that each unit of section 1245 property was sold at a gain. You may figure the ordinary income because of depreciation as if the 50 machines and 25 trucks were one item.

However, if 5 of the trucks had been sold at a loss, only the 50 machines and 20 of the trucks could be treated as one item in determining the ordinary income because of depreciation.

Normal retirement. The normal retirement of section 1245 property in multiple asset accounts does not require recognition of ordinary income because of depreciation if your method of accounting for asset retirements does not require recognition of that gain.

Depreciation Recapture on Real Property

A gain on the disposition of section 1250 property is treated as ordinary income to the extent of additional depreciation allowed or allowable on the property. See *Additional depreciation*, later.

Section 1250 property. This includes all real property that is subject to an allowance for depreciation and that is not nor has never been section 1245 property. It also includes leased property (such as a building) to which the lessee has made improvements that are subject to an allowance for depreciation, and the cost of acquiring a lease. A fee simple interest in land is not included because it is not depreciable.

If, because of a change in use, section 1250 property becomes section 1245 property in the hands of a taxpayer, it may never again be treated as section 1250 property by that taxpayer.

The deductions taken under either **ACRS** or **MACRS** are treated as ordinary income under section 1245 except for these deductions taken on the following properties which are treated as section 1250 property:

- 1) 15-year, 18-year, or 19-year real property and low-income housing that is residential rental property,
- 2) 15-year, 18-year, or 19-year real property and low-income housing that is used mostly outside of the United States,
- 3) 15-year, 18-year, or 19-year real property and low-income housing on which the alternate ACRS method of depreciation is taken, and
- 4) Low-income property.

For more information on 15-year, 18-year, and 19-year property, get Publication 534, *Depreciation*.

The ordinary income rules for gains on section 1250 property dispositions do not apply if:

- 1) You figure depreciation on the property using the straight line method or any other method as long as that method does not result in depreciation that is more than the amount that is figured by the straight line method, and you have held the property more than a year,
- 2) You realize a loss on the sale, exchange, or involuntary conversion of the property,
- 3) You dispose of residential low-income rental property that you held for 16 2/3 years or more (for low-income rental housing on which the special 60-month depreciation for rehabilitation expenditures was allowed, the 16 2/3

years started when the rehabilitated property was placed in service), or

- 4) You chose the alternate ACRS method for the types of 15-, 18-, or 19-year real property covered by the section 1250 rules.
- 5) You dispose of residential rental property or nonresidential real property placed in service after December 31, 1986, (or after July 31, 1986, if the election to use the MACRS method was made). Additional depreciation is not treated as ordinary income on the disposition of residential rental property and nonresidential real property because these properties are now depreciated using the straight line method.

Gain Treated as Ordinary Income

To find what part of the gain is treated as ordinary income follow these steps:

- 1) In a sale, exchange, or involuntary conversion of the property, figure the excess of the amount realized over the adjusted basis of the property (in any other disposition of the property, figure the excess of fair market value over adjusted basis).
- 2) Figure the additional depreciation for the periods after 1975, and
- 3) Multiply the smaller of (1) or (2) by the applicable percentage (discussed later).
If any gain is left after following this procedure (that is, if (1) is more than (2)) then:
- 4) Figure the additional depreciation for periods after 1969 but before 1976.
- 5) Multiply the smaller of the remaining gain ((1) less (2)) or (4) by the applicable percentage (discussed later), and
- 6) Add the results from (3) and (5) to arrive at the gain that is to be treated as ordinary income. See *Special rule for corporations*, below, for additional income corporations may have to report.

Part III, Form 4797, is used to figure the ordinary income part of section 1250 gain.

Additional Depreciation

If you hold section 1250 property longer than one year, the additional depreciation is the excess of actual depreciation adjustments over the depreciation figured for the same period using the straight line method. Treat any basis reduction for investment credit as a deduction for depreciation (see *Investment credit*, under *Depreciation Recapture on Personal Property*, earlier). If you hold section 1250 property for 1 year or less, all the depreciation is additional depreciation.

The additional depreciation for 15-, 18-, or 19-year real property is the excess of the amount allowed over the amount based on straight line depreciation for the recovery period you actually used for the property. The straight line method is applied without any reduction of the basis for 50% of the investment credit.

You will have additional depreciation if you use the regular ACRS method, the declining balance method, the sum of the years-digits method, the units-of-production method, any other method of rapid depreciation, or if you elect amortization. You will not have additional depreciation from the amortization of: certified pollution control facilities; on-the-job training and child-care facilities; expenditures to remove architectural and transportation barriers to people with disabilities and the elderly; or certain rehabilitation expenditures for certain historic structures.

Special rule for corporations. Corporations, other than S corporations, have an additional amount to recognize as ordinary income on the sale or other disposition of section 1250 property. The additional amount treated as ordinary income on the sale of section 1250 property is 20% of the

excess of the amount that would have been ordinary income if the property was section 1245 property, or section 1245 recovery property, over the amount treated as ordinary income under section 1250. Report this additional ordinary income on line 26(f) of Form 4797, Part III, in the same property column used for the amount recaptured under section 1250.

Depreciation taken by other taxpayers on other property. Additional depreciation includes all depreciation adjustments in the basis of section 1250 property whether allowed to you or another person (as for carryover basis property).

Example. Larry Johnson gives his son section 1250 property on which he took \$2,000 in depreciation deductions, of which \$500 is additional depreciation. Immediately after the gift, the son's adjusted basis in the property is the same as his father's and reflects the \$500 additional depreciation. On January 1 of the next year, after taking depreciation deductions of \$1,000 on the property, of which \$200 is additional depreciation, the son sells the property. At the time of sale, the additional depreciation is \$700 (\$500 allowed the father plus \$200 allowed the son).

Depreciation allowed or allowable. The greater of depreciation allowed or allowable (to any person who held the property if the depreciation was used in figuring its adjusted basis in your hands) is generally the amount to use in figuring the part of the gain to be reported as ordinary income. If you can show that the deduction allowed for any tax year was less than the amount allowable, the smaller figure will be the depreciation adjustment for figuring additional depreciation.

Property received by gift or inheritance. If the basis of section 1250 property you received as a gift, inheritance, or in a tax-free exchange, etc., is reduced by the depreciation that was either allowed or allowable to a former owner, a separate statement containing the information discussed earlier in this chapter, under *Records*, must be attached to your return for the year the property was acquired.

Retired or demolished property. The adjustments reflected in adjusted basis generally do not include deductions for depreciation on retired or demolished parts of section 1250 property, unless these deductions are reflected in the basis of replacement property that is section 1250 property.

Example. If a wing of a building is totally destroyed by fire, the depreciation adjustments figured in the adjusted basis of the building after the wing is destroyed do not include any deductions for depreciation on the destroyed wing, unless the wing is replaced and the adjustments for depreciation on the destroyed wing are reflected in the basis of the replacement property.

Useful life and salvage value. The useful life and salvage value you use to figure the amount that would have been the depreciation if you had used the straight line method are the same as that used under the depreciation method you actually used. Salvage value is not used for either the ACRS or MACRS methods of depreciation. If you did not use a useful life under the depreciation method actually used (such as with the units of production method), or if you did not take salvage value into account (such as with the declining balance method), the useful life or salvage value for figuring what would have been the straight line depreciation is the useful life and salvage value you would have used under the straight line method.

Property held by lessee. If a lessee makes a leasehold improvement, the lease period for figuring what would have been the straight line depreciation adjustments and for figuring the additional depreciation includes all renewal periods. This extension cannot extend the period taken into account to a period which exceeds the remaining

useful life of the improvement. The same rule applies to the cost of acquiring a lease.

Renewal period. This means any period for which the lease may be renewed, extended, or continued under an option exercisable by the lessee. However, the inclusion of renewal periods cannot extend the lease by more than two-thirds of the period that was the basis on which the actual depreciation adjustments were allowed.

Rehabilitation expenditures. A part of the special 60-month depreciation adjustment allowed for rehabilitation expenditures incurred in connection with low-income rental housing is additional depreciation. After 1986, the special 60-month treatment of expenditures is no longer available, unless the expenditures were incurred under a binding contract, or if rehabilitation began before 1987.

If the property is held 1 year or less after the expenses are incurred, the entire special depreciation adjustment is treated as additional depreciation. If the property is held more than 1 year after the expenses are incurred, the additional depreciation is the excess of the special depreciation adjustments from the rehabilitation expenditures over the adjustments that would have resulted had the straight line method and the normal useful life and salvage value been used.

Example. On January 4, 1990, Fred Plums, a calendar year taxpayer, sells real property, the entire basis of which is from the rehabilitation expenses of \$50,000 incurred in 1977. The property was placed in service on January 3, 1978, and under the special depreciation provisions for rehabilitation expenses was depreciated under the straight line method using a useful life of 60 months (5 years) and no salvage value. If Fred had used the regular straight line method, he would have used a salvage value of \$5,000 and a useful life of 15 years. Depreciation under the straight line method would be \$3,000 each year ($1/15 \times \$45,000$ (\$50,000 - \$5,000)). On January 1, 1990, the additional depreciation for the property was \$14,000, figured as follows:

	Depreciation claimed	Straight line depreciation	Additional depreciation
1978	\$10,000	\$ 3,000	\$ 7,000
1979	10,000	3,000	7,000
1980	10,000	3,000	7,000
1981	10,000	3,000	7,000
1982	10,000	3,000	7,000
1983		3,000	(3,000)
1984		3,000	(3,000)
1985		3,000	(3,000)
1986		3,000	(3,000)
1987		3,000	(3,000)
1988		3,000	(3,000)
1989		3,000	(3,000)
Total	\$50,000	\$36,000	\$ 14,000

Applicable Percentage

To figure the amount taxable as ordinary income because of additional depreciation, for real property you disposed of, you may have to use one or two applicable percentages depending on whether the property is nonresidential real property, residential real property, or low-income housing. The applicable percentages that must be applied to these types of real property are as follows.

Nonresidential real property. For real property, which is neither residential real property nor low-income housing, the applicable percentage is 100% for periods after 1989. For periods before 1970 the applicable percentage is zero and no ordinary income will result on its disposition because of additional depreciation before 1970.

Residential real property. For residential real property (85% or more of the gross income is from dwelling units), other than low-income housing, the applicable percentage for periods after 1975 is 100%. For residential rental property

(80% or more of the gross rental income is from dwelling units), the applicable percentage for periods after 1969 and before 1976 is 100% minus one percent for each full month the property was held in excess of 100 months. When this property has been held for at least 16 2/3 years, the applicable percentage is zero. No ordinary income because of additional depreciation will result on its disposition. The applicable percentage for periods before 1970 is zero. No ordinary income will result on its disposition because of additional depreciation before 1970.

Example. An apartment house that qualifies as residential rental property was acquired on January 2, 1975. It is sold on January 4, 1990. The excess of amount realized over its adjusted basis is \$50,000. Additional depreciation attributable to the property is \$20,000, of which \$18,000 is additional depreciation after 1975, and \$2,000 for additional depreciation after 1969 and before 1976. For the additional depreciation after 1975, the applicable percentage is 100%, and for after 1969 and before 1976, the percentage is 20%; that is, 100% minus 80% (180 months minus 100 months). Gain treated as ordinary income is figured as follows:

1) Excess of amount realized over adjusted basis	\$50,000
2) Additional depreciation after 1975	\$18,000

Additional steps are necessary because (1) exceeds (2):

3) Lesser of: (1), or (2), times 100%	\$18,000
4) Additional depreciation after 1969 and before 1976	\$2,000
5) Lesser of: (4), or the excess of (1) over (2), times 20%	400
Gain treated as ordinary income	<u>\$18,400</u>

The remaining gain of \$31,600 is reported in Part I, Form 4797. It is subject to tax under other provisions of the law relating to sales and exchanges. See the discussion under Chapter 5, *Reporting Gains and Losses*.

Low-income housing. Low-income housing includes the following types of property:

- 1) Federally assisted housing projects where the mortgage is insured under section 221(d)(3) or 236 of the National Housing Act, or housing financed or assisted by direct loan or tax abatement under similar provisions of state or local laws,
- 2) Low-income rental housing for which a depreciation deduction for rehabilitation expenditures was allowed,
- 3) Low-income rental housing held for occupancy by families or individuals who are eligible to receive subsidies under section 8 of the United States Housing Act of 1937, as amended, or under the provisions of state or local laws that authorize similar subsidies for low-income families, and
- 4) Housing financed or assisted by direct loan or insured under Title V of the Housing Act of 1949.

The applicable percentage for periods after 1975 for low-income housing is 100% minus one percent for each full month the property was held in excess of 100 full months.

For properties described in (2), (3), and (4) above, the applicable percentage for periods after 1969 and before 1976 is 100% minus one percent for each full month the property was held over 100 full months. However, for property described in (1) the applicable percentage is 100% minus one percent for each full month the property was held over 20 full months.

The applicable percentage for periods before 1970 is zero.

To figure the applicable percentage for low-income housing for which the special depreciation for rehabilitation expenses was allowed, the 100 full months start when the property was placed in service.

Example. On July 3, 1990, Bob Brown, a calendar year taxpayer, sold real property that was acquired on September 1, 1976. The excess of amount realized over adjusted basis is \$15,000.

The property qualified as low-income residential rental property under item (3) of the listing for each tax year after 1969. For the additional depreciation of \$3,500 after 1975, and for the additional depreciation of \$600, after 1969 but before 1976, the applicable percentage is 22%; that is, 100% minus 78% (178 months less 100 months). Gain treated as ordinary income is figured as follows:

1) Excess of amount realized over adjusted basis	\$15,000
2) Additional depreciation after 1975	\$ 3,500

Additional steps are necessary because (1) exceeds (2):

3) Lesser of: (1), or (2), times 22%	\$ 770
4) Additional depreciation after 1969 and before 1976	\$ 600
5) Lesser of: (4), or the excess of (1) over (2), times 22%	132
Gain treated as ordinary income	<u>\$ 902</u>

The remaining gain of \$14,098 is reported in Part I, Form 4797. This gain is sometimes treated as capital gain and sometimes as ordinary income under rules discussed later under Chapter 5, *Reporting Gains and Losses*.

Foreclosure. If section 1250 property is disposed of because of foreclosure or similar proceedings, the monthly percentage reduction of the additional depreciation is figured as if you disposed of the property on the starting date of the proceedings.

Example. On June 1, 1978, you acquired low-income rental property. On April 3, 1989 (130 months after the property was placed in service), foreclosure proceedings were started on the property and on December 1, 1990 (150 months after the property was placed in service), the property was disposed of as a result of the foreclosure proceedings. The low-income rental property qualified for the special additional depreciation monthly percentage reduction because it was held in excess of 100 full months (that is, one percent per month reduction after 100 months). The applicable percentage reduction will be 30% (130 months less 100 months) rather than 50% (150 months less 100 months) because the percentage reduction would not apply after March 31, 1989, the starting date of the foreclosure proceedings.

Holding period. To figure the applicable percentage, when it is less than 100%, the holding period for property acquired generally starts on the day after it is acquired. Thus, if you bought type (1) low-income housing (defined earlier) on January 1, 1975, the holding period starts on January 2, 1975. If you sold it on January 2, 1990, the holding period is exactly 180 full months. The applicable percentage for additional depreciation for periods after 1969 and before 1976 is 0% (100% reduced by a percentage equal to the number of full months in the holding period in excess of 20 months). The applicable percentage for additional depreciation after 1975 is 20%, that is, 100% minus 80%, or one percent for each full month it was held over 100 full months.

Constructed, reconstructed, or erected property. For property you constructed, reconstructed, or erected, the holding period starts on

the first day of the month in which it is placed in service in a trade or business, in the production of income, or in a personal activity.

Section 1250 property acquired by gift or received in a tax-free exchange. For section 1250 property acquired by gift or in a tax-free exchange, the basis of which is figured by reference to the basis in the hands of the transferor, the holding period, for the purpose of the applicable percentage, includes the holding period of the transferor.

If the adjusted basis of the property in the hands of the transferee just after the transaction is more than its adjusted basis to the transferor just before the transaction, the holding period of the excess is figured as if it were a **separate improvement**. This also applies to the sale of a main home and the buying of another one, if the adjusted basis of the home acquired is more than the adjusted basis of the one sold.

Property with Two or More Elements

If section 1250 property has more than one separate element, the gain to be reported as ordinary income is the sum of the ordinary income figured for each element.

Three types of separate elements are:

- 1) A separate improvement (defined later),
- 2) The basic section 1250 property plus improvements not qualifying as separate improvements, and
- 3) The units placed in service at different times before all of the section 1250 property is finished. For example, this happens when a taxpayer builds an apartment house of 100 units, and places 30 units in service (available for renting) on January 4, 1989, 50 on July 18, 1989, and the remaining 20 on January 19, 1990. As a result, the apartment house consists of three separate elements.

36-month test for separate improvements. A separate improvement is each improvement (qualifying under *One-year test*, below) added to the capital account of the property if the total of the improvements during the 36-month period ending on the last day of any one tax year is more than the greater of:

- 1) One-fourth of the adjusted basis of the property at the start of the first day of the 36-month period, or the first day of the holding period of the property, whichever is later,
- 2) One-tenth of the unadjusted basis of the property at the start of the first day of the 36-month period, or the first day of the holding period of the property, whichever is later, or
- 3) \$5,000.

One-year test. An addition to the capital account for any tax year is treated as an improvement only if the sum of all additions for the year is more than the larger of \$2,000, or one percent of the unadjusted basis of the property figured as of the start of that tax year or the holding period of the property, whichever is later. In applying the 36-month period test, improvements in any one of the 3 years are omitted entirely if the total improvements in that year do not qualify under the one-year test.

This one-year test is applied to all years following the acquisition of section 1250 property. If such property was acquired in 1979 and improved in 1989, it will be necessary to figure if the improvements made in 1989 qualify as a separate element with a separate holding period.

Example. Assume that the unadjusted basis of property is \$300,000 on January 1, 1990, for a calendar-year taxpayer. During the year the taxpayer

makes improvements A, B, and C which cost \$1,000, \$600, and \$700, respectively. Since the sum of the improvements, \$2,300, is less than one percent of the unadjusted basis (one percent is \$3,000), the improvements in 1990 do not satisfy the one-year test and are not treated as separate improvements for the 36-month period test. However, if improvement C cost \$1,500, the sum of the 1990 improvements would be \$3,100. It would then be necessary to apply the 36-month period test to figure if the improvements must be treated as separate improvements.

Addition to the capital account. Any addition to the capital account made after the initial acquisition or completion of the property by you or by any other person who held the property during a period included in your holding period is to be considered when figuring the total amount of separate improvements.

The addition to the capital account of depreciable real property is the **gross addition**, not reduced by amounts attributable to replaced property. Thus, if a roof with an adjusted basis of \$20,000 is replaced by a new roof costing \$50,000, the improvement is the gross addition to the account, \$50,000, and not the net addition of \$30,000. The \$20,000 adjusted basis of the old roof is no longer reflected in the basis of the property. The status of an addition to the capital account is not affected by whether it is treated as a separate property for purposes of determining depreciation deductions.

Whether an addition to the capital account is to be treated as a separate improvement may depend on the final disposition of the entire property. If the addition to the property and the original property are sold in two separate transactions, the entire section 1250 property is treated as consisting of two distinct items.

The adjusted basis. The adjusted basis under (1) of the previous listing and the unadjusted basis under (2) include the depreciated cost and the actual cost of all improvements, along with those that do not qualify as separate improvements. However, neither the adjusted nor the unadjusted basis includes the cost of retired components that are no longer part of the section 1250 property, unless the adjusted basis of these is reflected in the basis of the replacement property.

Holding period. The following guidelines are used for figuring the holding period and applicable percentage for property with two or more elements:

- 1) The holding period of a separate element placed in service before the entire section 1250 property is finished starts on the first day of the month that the separate element is placed in service;
- 2) The holding period for each separate improvement starts on the day after the property was acquired or, for property constructed, reconstructed, or erected, the first day of the month that the property was placed in service; whereas
- 3) The holding period for each improvement **not** qualifying as a separate element is treated as part of the original property and takes the holding period of the original property for figuring the applicable percentage.

If you consider an improvement by itself and it does not meet the one-year test (greater of \$2,000 or one percent of the unadjusted basis), but it does qualify as a separate improvement that is a separate element (when grouped with other improvements made during the tax year which also did not meet the one-year test), determine the start of the holding period as follows: Use the first day of the calendar month that is closest to the middle of the tax year. If there are two dates that are equally close to the middle of the year, use the earlier date.

Figuring ordinary income attributable to each separate element. Figure ordinary income attributable to each separate element as follows—

Step 1. Divide the element's additional depreciation after 1975 by the sum of all elements' additional depreciation after 1975 to determine a percentage.

Step 2. Multiply the percentage figured in Step 1 by the lesser of the additional depreciation after 1975 for the entire property or the gain from disposition of the entire property (the difference between the fair market value, or amount realized, and the adjusted basis).

Step 3. Multiply the result in Step 2 by the applicable percentage for the element.

Leftover gain. For any gain that is left, you must apply the following steps:

Step 4. Figure the ratio of the element's additional depreciation after 1969 and before 1976 to the sum of all elements' additional depreciation after 1969 and before 1976.

Step 5. Multiply the ratio figured in Step 4 by the lesser of the additional depreciation after 1969 and before 1976 for the entire property or the remaining gain from disposition of the entire property.

Step 6. Multiply the result in Step 5 by the applicable percentage for the element.

Example. You sold property at a gain of \$25,000 that was subject to the ordinary income rules of section 1250. The property consisted of four elements (W, X, Y, and Z). The additional depreciation for each element was: W—\$12,000; X—None; Y—\$6,000; and Z—\$6,000. The sum of the additional depreciation for all the elements (Step 1) is \$24,000. The depreciation deducted on element X was \$4,000 less than it would have been under the straight line method. Depreciation on the property as a whole was \$20,000 (\$24,000 minus \$4,000). Because \$20,000 is lower than the \$25,000 gain on the sale, the \$20,000 is used in Step 2. The applicable percentages to be used in Step 3 for the elements were: W—68%; X—85%; Y—92%; and Z—100%.

From these facts, the sum of the ordinary income for each element is computed as follows:

	Step 1	Step 2	Step 3	Ordinary income
W	\$12,000 ÷ \$24,000	\$20,000	68%	\$ 6,800
X	\$0 ÷ \$24,000	\$20,000	85%	0
Y	\$6,000 ÷ \$24,000	\$20,000	92%	4,600
Z	\$6,000 ÷ \$24,000	\$20,000	100%	5,000
Sum of the ordinary income of the separate elements				\$16,400

Installment Sales

A gain from the sale of depreciable personal property or real property must be reported under the installment method, unless you elect not to have this method apply.

Any recapture of depreciation, including the section 179 deduction, is taxable as ordinary income under section 1245 or 1250 in the year of sale up to the amount of the gain, even if no payments are received in that year. If the gain is more than the depreciation recapture income, report the remainder of the gain using the rules of the installment method. For this purpose, add the recapture income to the property's adjusted basis.

If you dispose of **more than one asset** in a single transaction, you must separately figure the gain on each asset so that it may be properly reported. To do this, allocate the selling price and the payments you receive in the year of sale to

each asset. Any depreciation recapture income must be reported in the year of sale up to the amount of gain for each asset before capital gain treatment is allowed on any remaining gain.

For a detailed discussion of installment sales, get Publication 537.

Other Dispositions

If you make a **gift** of depreciable personal property or real property, you are not required to report income on the transaction. However, if the person who receives it (donee) sells or otherwise disposes of the property and this subsequent disposition is subject to recapture, the donee must take into account the depreciation that you deducted in figuring the gain to be reported as ordinary income.

For depreciable real property on which the applicable percentage is less than 100%, depending on how long the property was held, the donee must take into account the donor's holding period to figure the applicable percentage. See *Applicable Percentage* and its discussion, *Holding period under Depreciation Recapture on Real Property*.

Disposition part gift and part sale or exchange.

If you transfer depreciable personal property or real property for less than its fair market value, in a transaction considered to be partly a gift and partly a sale or exchange, and you have a gain because the amount realized is more than your adjusted basis, you must report ordinary income (up to the amount of gain) to recapture depreciation. If the depreciation is more than the gain, the balance of your depreciation is carried over to the transferee, to be taken into account on any later disposition of the property. See *Gift to charitable organization*, later.

Example. You transfer depreciable personal property to your son for \$20,000. When transferred, the property had an adjusted basis to you of \$10,000 and a fair market value of \$40,000. You had taken depreciation of \$30,000. You are considered to have made a gift of \$20,000, the difference between the \$40,000 fair market value and the \$20,000 sale price to your son. You have a taxable gain on the transfer of \$10,000 (\$20,000 sale price less \$10,000 adjusted basis) that must be reported as ordinary income because of depreciation. Because you report \$10,000 of your \$30,000 depreciation as ordinary income on the transfer of the property, only the remaining \$20,000 is carried over to your son, to be taken into account by him on any later disposition of the property.

Gift to charitable organization. If your gift is to a charitable organization, the amount of your charitable contribution of property must be reduced by the ordinary income and short-term capital gain that would result had you sold the property at its fair market value at the time of the contribution. Also, you may have to reduce the amount of your charitable contribution of property by the long-term capital gain that would result if you sold the property at its fair market value at the time of the contribution. The fair market value of depreciable real or personal property given to a charitable organization must always be reduced by the potential ordinary gain because of depreciation.

For more information on charitable contributions, get Publication 526, *Charitable Contributions*.

Bargain sale to charitable organization. A bargain sale is a sale or exchange of property to a charitable organization for less than its fair market value. It results in a transaction that is partly a sale or exchange and partly a charitable contribution. A special computation must be made to figure 1) the gain from the part of the transaction that is a sale, and 2) the amount of any deductible charitable contribution. Primarily, the adjusted basis of the property must be divided between the part sold

and the part given to charity. See *Allocation of basis*, next.

If a deduction for the contribution is not allowable, the transaction is treated as a regular sale. In that case, any gain is figured (without allocation of basis) in the normal manner (selling price less adjusted basis of entire property).

Allocation of basis. If a bargain sale results in a charitable contribution, the adjusted basis of the property must be allocated between the part of the property sold and the part of the property given to the charity. The **adjusted basis of the contributed part** is figured as follows:

$$\text{Adjusted basis of entire property} \times \frac{\text{Fair market value of contributed part}}{\text{Fair market value of entire property}}$$

To determine the fair market value of the contributed part, subtract the amount you realized on the sale (or the selling price) from the fair market value of the entire property.

The **adjusted basis of the sold portion** is figured as follows:

$$\text{Adjusted basis of entire property} \times \frac{\text{Amount realized (fair market value of part sold)}}{\text{Fair market value of entire property}}$$

Example. In 1990 you sell depreciable personal property to a charitable organization for its adjusted basis of \$12,000. The property has a fair market value of \$25,000. It originally cost \$22,000 and you claimed depreciation of \$10,000 for it. If you sold the property at its fair market value at the time of the contribution, it is assumed that \$10,000 of the nonrecognized gain of \$13,000 (\$25,000 minus \$12,000 adjusted basis) would have been recognized as ordinary income and the remaining \$3,000 as long-term capital gain. You made a charitable gift to the organization of \$13,000 (\$25,000 minus \$12,000 selling price). To determine the amount you can deduct, you must reduce the gift by the gain that would have been recognized if the contributed part of the property were sold at its fair market value (FMV) at the time of the contribution. For this example, assume that the gain used to reduce the gift includes long-term capital gain.

The sale of your property is a bargain sale resulting in a charitable contribution. To figure 1) your gain on the part sold, and 2) the deduction you can take for the part contributed, you must allocate 48% (\$12,000 selling price, or amount realized, divided by \$25,000 FMV of the entire property) of the adjusted basis to the part sold and 52% (\$13,000 FMV of the gift divided by \$25,000) to the part contributed. Using these allocation percentages, you figure that your long-term capital gain is \$1,440.

Gain on part sold:

Sales price	\$12,000
Less: Basis (48% × \$12,000)	5,760
Total gain on part sold	\$ 6,240
Less: Ordinary income (48% × \$10,000)	4,800
Long-term capital gain	\$ 1,440

Your charitable contribution deduction is \$6,240, as follows:

Deductible charitable contribution:

Value of contribution	\$13,000
Less: Non-recognized gain or bargain sale that would have been recognized if the contributed part of the property were sold at its FMV at the time of the contribution:	
FMV of contributed part	\$13,000
Less: Adjusted basis (52% of \$12,000)	6,240
Contribution deduction allowable	\$ 6,240

You can also figure your deductible contribution by reducing the amount of the contribution by 52% of the ordinary income and long-term capital gain attributable to the contributed part of the property, as follows:

Value of Contribution	\$13,000
Less: Ordinary income (\$10,000 × 52%)	\$5,200
Less: Long-term capital gain (\$3,000 × 52%)	1,560
Amount of contribution	\$ 6,240

Transfers at Death

When a taxpayer dies, no gain is reported on depreciable personal property or real property that is transferred to his or her estate or beneficiary. For information on the tax liability of a decedent, get Publication 559, *Tax Information for Survivors, Executors, and Administrators* and Publication 551.

However, if the taxpayer disposed of the property while alive and, because of the method of accounting used or for any other reason, the gain from the disposition is reportable by the estate or beneficiary, it must be reported the same way the decedent would have been required to report if he or she were alive.

Ordinary income due to depreciation must be reported on a transfer from an executor, administrator, or trustee to an heir, beneficiary, or other individual if the transfer is a sale or exchange on which a gain is realized.

Example 1. Janet Smith owns depreciable property that, on her death, is inherited by her son. No ordinary income because of depreciation is reportable on the transfer, even though the value used for estate tax purposes is more than the adjusted basis of the property to Janet when she died. However, if she had sold the property before her death and realized a gain, and if because of her method of accounting, the proceeds from the sale were income in respect of a decedent reportable by her son, he would have to report ordinary income because of depreciation.

Example 2. The trustee of a trust, which was created by a will, transfers depreciable property to a beneficiary in satisfaction of a specific bequest of \$10,000. If the property had a value of \$9,000 at the date used for estate tax evaluation purposes, the \$1,000 increase in value to the date of distribution is a gain realized by the trust. Ordinary income because of depreciation must be reported by the trust on the transfer.

Like-Kind Exchanges and Involuntary Conversions

A like-kind exchange of your personal property, or an involuntary conversion of the property because of a casualty, theft, or condemnation for public use (or threat or imminence thereof), will not result in your having to report ordinary income because of depreciation unless property other than depreciable personal property is received in the transaction.

Other than depreciable personal property. If you receive property other than depreciable personal property and you include gain as ordinary income because of depreciation, the amount is limited to the **smaller** of:

- 1) The gain on the transaction up to the amount of depreciation deducted, or
- 2) The gain that must be included in income under the rules for like-kind exchanges or involuntary conversions, **plus** the fair market value of property other than depreciable personal property acquired in the transaction.

Example 1. On January 4, 1990, you bought a new machine for \$4,300 cash plus your old machine for which you were allowed a \$1,360 trade-in. The old machine cost you \$5,000 on January 2, 1986. For 1986 through 1989, you take ACRS deductions of \$750, \$1,100, \$1,050, and \$1,050. Even though \$3,950 has been deducted under ACRS, the \$310 gain (\$1,360 trade-in allowance less \$1,050 adjusted basis) is not reported because any tax on the gain is postponed and you received only depreciable personal property in the exchange.

Example 2. On January 4, 1988, you bought office machinery for \$1,500. You deducted \$300 and \$480 under MACRS on your 1988 and 1989 returns. On January 3, 1990, a fire destroyed the machinery and you received \$1,200 from your fire insurance. However, replacement machinery cost you only \$1,000. (See the discussion of *Replacement property* in Publication 547.) Your taxable gain is limited to the remaining \$200 insurance payment. Because your taxable gain is less than the \$780 MACRS deduction you deducted, the \$200 is reported as ordinary income.

Example 3. In 1990 a fire destroyed office machinery you purchased in 1986 for \$116,000. The ACRS deductions were \$91,640, and the machinery had an adjusted basis of \$24,360. You got a \$117,000 insurance payment, realizing a gain of \$92,640.

You immediately spent \$105,000 of the insurance payment for replacement machinery and \$9,000 for stock that qualifies as replacement property, and you chose to postpone the tax on your gain. Because \$114,000 of the \$117,000 insurance payment was used to buy replacement property, the gain that must be included in income under the rules for involuntary conversions is the unexpended part or \$3,000. Also, the part of the insurance payment (\$9,000) used to buy the non-depreciable property (the stock) also must be included in figuring the gain because of depreciation.

The amount you must report as ordinary income on the transaction on your 1990 return is \$12,000, figured as follows:

1) Gain realized on the transaction (\$92,640) limited to depreciation (\$91,640)	\$91,640
2) Gain includible in income	\$3,000
Fair market value of property other than depreciable personal property (the stock)	9,000
Total	\$12,000
Amount reportable as ordinary income (lesser of (1) or (2))	\$12,000

If, instead of buying \$9,000 in stock you had bought \$9,000 worth of depreciable personal property that was similar or related in use to the destroyed property, you would only report \$3,000 as ordinary income.

Depreciable real property. If you have a gain from a like-kind exchange of your real property or from an involuntary conversion, the amount to be reported as ordinary income because of additional depreciation is limited to the **larger** of:

- 1) The gain that must be reported under the rules for like-kind exchanges or involuntary conversions, **plus** the fair market value of stock purchased as replacement property in acquiring control of a corporation, or
- 2) The gain you would have had to report as ordinary income because of additional depreciation had the transaction been a cash sale **less** the cost (or fair market value of an exchange) of the depreciable real property acquired.

The ordinary income not reported for the year of the disposition is carried over to the depreciable real property acquired in the like-kind exchange or involuntary conversion as additional depreciation from the property disposed of. Further, to figure the applicable percentage of additional depreciation to be treated as ordinary income, the holding period starts over for the new property.

Example. The state paid you \$116,000 when it condemned your depreciable real property for public use. You bought other real property, similar in use to the property condemned, for \$110,000 (\$15,000 for depreciable real property and \$95,000 for land). You also bought stock for \$5,000 to get control of a corporation owning property similar in use to the property condemned. You chose to postpone the tax on the gain. If the transaction had been a sale for cash only, under the rules described earlier, \$20,000 would have been reportable as ordinary income because of additional depreciation.

The ordinary income to be reported is \$6,000, which is the larger of:

- 1) The gain that would be required to be reported, \$1,000 (\$116,000 - \$115,000) **plus** the fair market value of stock bought as qualified replacement property, \$5,000, for a total of \$6,000, or
- 2) The gain you would have had to report as ordinary income because of additional depreciation (\$20,000) had this transaction been a cash sale, **less** the cost of the depreciable real property bought (\$15,000), or \$5,000.

Basis of real property acquired in involuntary conversions. If only depreciable real property is acquired to replace depreciable real property in an involuntary conversion in which gain is realized, and tax on the gain is postponed under the rules for involuntary conversions, the basis of the replacement property is its cost less the gain on which tax is postponed. If the replacement consists of more than one piece of depreciable real property, the cost of each piece is reduced by an allocable part of the gain.

However, if the replacement property consists of **both depreciable real property and other property**, the basis must be figured as follows:

- 1) Figure a tentative basis for the depreciable real property by subtracting from its cost the ordinary income because of additional depreciation that is not required to be reported (if more than one piece of depreciable property is acquired, the tentative basis must be allocated to each piece in proportion to its cost),
- 2) Add the tentative basis figured in (1) to the cost of the other property acquired,
- 3) Subtract from the total in (2) the excess of gain on which tax is postponed over the ordinary income because of additional depreciation not required to be reported, and finally
- 4) Allocate the amount obtained in (3) to each asset in proportion to its cost, as listed in (2).

Example 1. You receive an insurance payment of \$90,000 because of the destruction by fire of depreciable real property (an office building you acquired in 1980) that had an adjusted basis of \$73,000, with additional depreciation of \$10,000.

Your realized gain from the involuntary conversion is \$17,000. Under the general rules for dispositions of depreciable real property, you would report \$10,000 (lesser of \$10,000 additional depreciation or your \$17,000 gain) as ordinary income because of additional depreciation. You immediately spend the \$90,000 for depreciable real property similar in use to the property destroyed. Since you choose to postpone the tax on the gain, no income from the additional depreciation must be reported under the special rule for involuntary conversions, discussed earlier.

The basis of the replacement property is its cost of \$90,000 less the \$17,000 gain on which tax is postponed, or \$73,000. The \$10,000 of ordinary income that you would otherwise be required to report is carried over to the replacement property as additional depreciation. The holding period of the newly acquired property includes the period during which you held the converted property.

Example 2. John Adams gets a \$90,000 fire insurance payment for depreciable real property (office building) with an adjusted basis of \$30,000. He uses the whole payment to buy property similar in use, of which \$42,000 is for depreciable real property and \$48,000 is for land. He chooses to postpone the tax on the \$60,000 gain realized on the involuntary conversion. Of this gain \$10,000 is ordinary income because of additional depreciation, but is not reported because of the exception for involuntary conversions. The basis of the property bought is \$30,000, figured and allocated as follows:

- 1) The tentative basis of depreciable real property is \$32,000 (cost of \$42,000, less \$10,000 ordinary income not required to be reported).
- 2) The tentative basis of depreciable real property plus the cost of other property (land) is \$80,000 (\$32,000 plus \$48,000).
- 3) Subtract from the \$80,000 figured in (2) the difference between \$60,000, the gain on which tax is postponed without regard to the rules described earlier, and \$10,000, the ordinary income because of additional depreciation that is not required to be reported. The difference is \$50,000 which, subtracted from \$80,000, leaves \$30,000.
- 4) Allocate the result in (3) to both properties by their costs, as determined in (2).

Depreciable real property	
$\$32,000 \div \$80,000 \times \$30,000 =$	\$12,000
Other property (land)	
$\$48,000 \div \$80,000 \times \$30,000 =$	\$18,000

The ordinary income not required to be reported (\$10,000) is carried over as additional depreciation to the depreciable real property that was bought, and may be taxed on a later disposition. The holding period of the property that was bought includes the holding period of the exchanged or involuntarily converted property. For figuring the applicable percentage on the property that was bought, a new holding period begins on the day after the property was bought.

Depreciable Property and Other Property in One Transaction

If you dispose of both depreciable personal property and other property in one transaction and realize a gain, you must allocate the amount realized between the two types of property disposed of in proportion to their respective fair market values to figure the part of your gain to be reported as ordinary income because of depreciation. (Special rules may apply to the allocation of the

purchase price on the sale of a group of assets; see Publication 551.)

In general, if a buyer and seller have adverse interests as to the allocation of the amount realized between the depreciable personal property and other property, any arm's length agreement between them will establish the allocation.

In the absence of an agreement, the allocation should be made by taking into account the appropriate facts and circumstances. This would include, but is not limited to, a comparison between the depreciable personal property and the property disposed of in the transaction. The comparison should take into account:

- 1) The original cost and reproduction cost of construction, erection, or production,
- 2) The remaining economic useful life,
- 3) The state of obsolescence, and
- 4) The anticipated expenditures required to maintain, renovate, or modernize the properties.

In a like-kind exchange or involuntary conversion, if both depreciable personal property and other property are disposed of and both types are also acquired in the transaction, the part realized on the disposition that is allocated to the depreciable personal property is treated as consisting of, first, the fair market value of the depreciable personal property acquired and, second (to the extent of any remaining balance), the fair market value of property other than depreciable personal property acquired. The amount allocated to the other property disposed of is treated as consisting of the fair market value of all property acquired that has not already been taken into account.

If you dispose of **depreciable real property** and other property in a single transaction, similar rules apply.

Example. A fire destroyed your property having a total fair market value of \$50,000, consisting of machinery worth \$30,000 and other property worth \$20,000. You received an insurance payment of \$40,000 and immediately used it plus \$10,000 of your own funds (or a total of \$50,000) to buy machinery with a fair market value of \$15,000 and other property with a fair market value of \$35,000. Assume that your adjusted basis of the machinery was \$5,000 and the depreciation on the machinery was \$35,000. Assume further that you chose to postpone the tax on your gain arising from the involuntary conversion. You must report \$9,000 as ordinary income because of depreciation arising from this transaction, figured as follows:

First, the \$40,000 insurance payment must be allocated between the machinery and the other property destroyed, in proportion to the fair market value of each. The amount allocated to the machinery is 30,000/50,000 of \$40,000, or \$24,000. The amount allocated to the other property is 20,000/50,000 of \$40,000, or \$16,000. Your gain on the involuntary conversion of the machinery is \$24,000 less \$5,000 adjusted basis, or \$19,000.

Second, the \$24,000 allocated to the machinery disposed of is treated as consisting of the \$15,000 fair market value of the replacement machinery bought and \$9,000 of the fair market value of other property bought in the transaction. All \$16,000 allocated to the other property disposed of is treated as consisting of the fair market value of the other property that was bought.

Third, you must report as ordinary income because of depreciation the smaller of items (1) or (2) listed under *Like-Kind Exchanges and Involuntary Conversions* and its discussion *Other than depreciable personal property*, earlier. Under item (1) account for your \$19,000 gain on the machinery because it is less than the \$35,000 depreciation. Under item (2), do not account for the gain

included in income because you chose to postpone the tax on your gain. You must also account for the \$9,000 which represents the fair market value of property other than the depreciable property you bought. This \$9,000 is included in the payment for the machinery you disposed of. You must report the smaller of (1) or (2), \$9,000, as ordinary income because of depreciation.

Corporations and Partnerships

Corporations and partnerships figure ordinary income on the disposition of either depreciable personal or depreciable real property in the same way as for individuals described earlier. Although the computations differ for each type of property in arriving at the gain to be reported as ordinary income, once the gain is figured, the treatment of the transaction is generally the same.

For information on depreciable property distributed by corporations, see *Distributions of Depreciable Property* in Publication 542, *Tax Information on Corporations*.

Chapter 5 Reporting Gains and Losses

Capital gains and losses are reported on Schedule D (Form 1040). This schedule is also used to figure the limit on capital losses, to figure capital gains, and any capital loss carryovers from 1990 to 1991.

Report any net section 1231 gain from Part I, Form 4797 on Schedule D (Form 1040). This amount includes any net gain from sales, exchanges, and involuntary conversions of real or depreciable property used in your trade or business (or held for the production of rents or royalties). This amount also includes any net gain from involuntary conversions of capital assets used in your trade or business (or a transaction entered into for profit) held for more than one year. See *Section 1231 Property* in Chapter 4. Losses from involuntary conversions of property are discussed later under Form 4797.

Although this discussion refers to Schedule D (Form 1040), the rules discussed here also apply to taxpayers other than individuals. The rules for property held for personal use, however, usually will not apply to taxpayers other than individuals. Form 4797 is used along with Form 1040, as well as with such Forms as 1065, 1120, and 1120S.

Form 1099-B. If you sold stocks, bonds, commodities, etc., you should receive Form 1099-B, *Statement for Recipients of Proceeds From Broker and Barter Exchange Transactions*, or an equivalent statement. Use Form 1099-B or the equivalent statement to fill in line 1 of Schedule D (Form 1040).

Whether or not you receive Form 1099-B, you must report all taxable sales of stocks, bonds, commodities, etc., on Schedule D. For more information about figuring gains and losses from these transactions, see *Sales and Trades of Investment Property*, in Publication 550.

Real estate transactions. Information reporting must be provided on certain real estate transactions. For closings in 1990, generally the person responsible for closing the transaction must report to the IRS on Form 1099-S, *Statement for Recipients of Proceeds From Real Estate Transactions*, sales or exchanges of the following:

- 1) A single-family residence, such as a house, townhouse, or condominium unit,
- 2) A multi-family residence with four or fewer units, or

- 3) Stock in a cooperative housing corporation.

If you have sold or exchanged the above types of property, the reporting person must give you a copy of Form 1099-S or a statement containing the same information as the Form 1099-S. Also use Form 1099-S to fill in the gross proceeds requested on line 1 of Form 4797 or the form you are using to report the sale or exchange.

Note. If you receive or will receive property or services in addition to gross proceeds (cash or notes) in this transaction, the person reporting it is not required to value that property or those services. In that case, the gross proceeds reported on Form 1099-S will be less than the sales price of the property you sold. After you include the gross proceeds amount on line 1 of Form 4797, figure any gain or loss according to the sales price, which is the total amount you realized on the transaction.

Schedule D (Form 1040)

Gain or loss on the sale or exchange of capital assets held one year or less is a short-term capital gain or loss and is reported in Part I.

Gain. Gain on the sale or exchange of property held for personal use (such as your residence) and held for one year or less is a short-term capital gain. **Loss** on the sale or exchange of property held for personal use is not deductible.

Combine your share of short-term capital gains or losses from partnerships, S corporations, or fiduciaries with any short-term capital loss carryover and other short-term gains and losses to figure net short-term capital gain or loss.

Long-term gains and losses. Gain or loss on the sale or exchange of capital assets held more than one year is a long-term capital gain or loss and is reported in Part II.

Gain. Gain on the sale or exchange of property held for personal use (such as your residence) and held more than one year is a long-term capital gain. **Loss** on the sale or exchange of property held for personal use is not deductible.

Net long-term gain. Net section 1231 gain from Part I, Form 4797, after adjustment for nonrecaptured section 1231 losses from prior tax years, if applicable, is a long-term capital gain. It is reported in Part II of Schedule D (Form 1040). The following are also reported in Part II:

- 1) Capital gain distributions from regulated investment companies, mutual funds, and real estate investment trusts.
- 2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries.
- 3) Long-term capital loss carryovers.
- 4) Your capital gain distributions, unless you do not need to report any other capital gains or losses. In this case, report capital gain distributions on Form 1040.

The result from combining these items is your net long-term capital gain or loss.

Total net gain or loss. You figure your total net gain or loss by combining your net short-term capital gain or loss with your net long-term capital gain or loss. Enter the result on line 18, Part III. If losses are more than gains, see *Treatment of Capital Losses*, in Chapter 3.

Form 4797

A sale, exchange, or involuntary conversion of property used in your trade or business or held for the production of rents or royalties sometimes results in either a capital gain or loss, or an ordinary gain or loss. All or part of any gain from the disposition of such property may be ordinary gain

from depreciation under the rules described in Chapter 4.

Gains and losses from involuntary conversions of capital assets held for more than one year, in connection with a transaction entered into for profit, may be treated as capital or ordinary gains and losses, depending on the circumstances. You can sometimes choose to postpone tax on gains from involuntary conversions by acquiring qualified replacement property within a specified period. For information on casualties and thefts, see Publication 547.

Form 4797 is used to report these transactions and to figure the amount of ordinary or capital gain or loss.

Installment method. The long-term gain you recognize each year from a taxable sale of business real or depreciable property under the installment method of accounting may be a long-term capital gain in one year and an ordinary gain in another because of section 1231 treatment. After figuring the taxable part of the installment sale on Form 6252, *Installment Sale Income*, include the amount of gain on Form 4797.

For information on the treatment of gain attributable to depreciation for a transaction reported by the installment method, see Chapter 4.

Repossession. If the original sale was reported on the installment method of accounting, the taxable gain on repossession would keep the same classification as the gain on the original sale. Thus, if the sale initially resulted in a capital gain, the repossession gain would be a capital gain also.

The treatment of losses on repossessions depends upon whether the property being repossessed is real or personal property. For more information, see *Repossessions*, in Publication 537.

Example

Jane Smith is single and at the beginning of 1990, she owned and operated Jane's Dress Shop. During the year she traded the land and building where she operated her dress shop for other land and a building. She then opened the J. Smith Hardware Store. For the 1990 tax year, she had the following transactions, which are reported as shown in the accompanying filled-in Form 4797.

Form 4797

In March 1990 Jane decided to quit the dress shop and go into the hardware business. She made an even exchange of the land and building where she operated her dress shop for land and a building suitable for use as a hardware store. This was a nontaxable exchange. The basis of the new land and building is the same as the basis of the old land and building that was traded. She must allocate this basis between the new land and building in order to figure the depreciation and other deductions on the new building.

Jane was also able to sell all the equipment she had used in her dress shop for \$3,000 on March 16, 1990. She had originally paid \$6,000 for it on May 21, 1982, and had deducted \$4,000 in depreciation since then. Therefore, she realized a gain of \$1,000. Because the gain was less than the depreciation taken, all of the gain is ordinary income from depreciation. This amount is reported in Part III of Form 4797 and entered in Part II, line 13.

In March 1990 Jane also sold a small vacant lot (acquired in 1975) located across the street from the dress shop, which had been used as parking for her customers. Her adjusted basis was \$6,000. She received \$8,000 on the sale, realizing a section 1231 gain of \$2,000 shown on line 7, Part I. Jane also has a net section 1231 loss from a 1987 sale of section 1250 property. She did not have any net section 1231 losses in 1985 or 1986. Nor did Jane have any net section 1231 gains in

1988 or 1989. Jane enters her net section 1231 loss of \$1,200 as a nonrecaptured loss on line 8. Since the net section 1231 gain of \$2,000 is more than the nonrecaptured loss, that gain is treated as ordinary gain only up to the amount of the loss. Therefore, the loss amount of \$1,200 on line 8 is entered as an ordinary gain on line 12. Also, the

loss is subtracted from the \$2,000 gain on line 7. The \$800 balance on line 9 is a long-term capital gain entered on Schedule D.

Summary. The entries in Part II, Form 4797, show an ordinary gain of \$2,200, which is carried to line 15, Form 1040.

The entries in Part I, Form 4797, result in a gain of \$800 from section 1231 transactions. This is treated as a long-term capital gain and is carried to line 14, Schedule D (Form 1040).

Form **4797**

Sales of Business Property

(Also, Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F)

Department of the Treasury
Internal Revenue Service

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184

1990Attachment
Sequence No. 27

Name(s) shown on return

Jane Smith

Identifying number

458-00-0327

Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty and Theft—Property Held More Than 1 Year

1 Enter here the gross proceeds from the sale or exchange of real estate reported to you for 1990 on Form(s) 1099-S (or a substitute statement) that you will be including on lines 2, 10, or 20 1

(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) LOSS ((f) minus the sum of (d) and (e))	(h) GAIN ((d) plus (e) minus (f))
2 Store parking lot	10-1-75	3-14-90	8,000	-0-	6,000	-0-	2,000
Land and building	6-2-87	3-1-90	Line-kind Exchange, Form 8824 attached *				-0-

3 Gain, if any, from Form 4684, Section B, line 21

4 Section 1231 gain from installment sales from Form 6252, line 22 or 30

5 Gain, if any, from line 32, from other than casualty and theft

6 Add lines 2 through 5 in columns (g) and (h)

7 Combine columns (g) and (h) of line 6. Enter gain or (loss) here, and on the appropriate line as follows:

Partnerships.—Enter the gain or (loss) on Form 1065, Schedule K, line 6. Skip lines 8, 9, 11, and 12 below.

S corporations.—Report the gain or (loss) following the instructions for Form 1120S, Schedule K, lines 5 and 6. Skip lines 8, 9, 11, and 12 below, unless line 7 is a gain and the S corporation is subject to the capital gains tax.

All others.—If line 7 is zero or a loss, enter the amount on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain as a long-term capital gain on Schedule D and skip lines 8, 9, and 12 below.

8 Nonrecaptured net section 1231 losses from prior years (see instructions)

9 Subtract line 8 from line 7. If zero or less, enter -0-. Also enter on the appropriate line as follows (see instructions):

S corporations.—Enter this amount (if greater than zero) on Form 1120S, Schedule D, line 7, and skip lines 11 and 12 below.

All others.—If line 9 is zero, enter the amount from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below, and enter the amount from line 9 as a long-term capital gain on Schedule D.

Part II Ordinary Gains and Losses

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11 Loss, if any, from line 7

12 Gain, if any, from line 7, or amount from line 8 if applicable

13 Gain, if any, from line 31

14 Net gain or (loss) from Form 4684, Section B, lines 13 and 20a

15 Ordinary gain from installment sales from Form 6252, line 21 or 29

16 Recapture of section 179 deduction for partners and S corporation shareholders from property dispositions by partnerships and S corporations (see instructions)

17 Add lines 10 through 16 in columns (g) and (h)

18 Combine columns (g) and (h) of line 17. Enter gain or (loss) here, and on the appropriate line as follows:

a For all except individual returns: Enter the gain or (loss) from line 18 on the return being filed.

b For individual returns:

(1) If the loss on line 11 includes a loss from Form 4684, Section B, Part II, column (b)(ii), enter that part of the loss here and on line 21 of Schedule A (Form 1040). Identify as from "Form 4797, line 18b(1)". See instructions

(2) Redetermine the gain or (loss) on line 18, excluding the loss, if any, on line 18b(1). Enter here and on Form 1040, line 15

For Paperwork Reduction Act Notice, see page 1 of separate instructions.

Form 4797 (1990)

* Form 8824, Line-kind Exchanges, is not shown.

Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255

19	Description of section 1245, 1250, 1252, 1254, and 1255 property:	Date acquired (mo., day, yr.)	Date sold (mo., day, yr.)
A	Store equipment	5-20-83	3-16-90
B			
C			
D			

Relate lines 19A through 19D to these columns	Property A	Property B	Property C	Property D
20 Gross sales price (Note: See line 1 before completing.)	3,000			
21 Cost or other basis plus expense of sale	6,000			
22 Depreciation (or depletion) allowed or allowable	4,000			
23 Adjusted basis. Subtract line 22 from line 21	2,000			
24 Total gain. Subtract line 23 from line 20	1,000			
25 If section 1245 property:				
a Depreciation allowed or allowable from line 22	4,000			
b Enter the smaller of line 24 or 25a	1,000			
26 If section 1250 property: If straight line depreciation was used, enter zero on line 26g unless you are a corporation subject to section 291.				
a Additional depreciation after 12/31/75 (see Instructions)				
b Applicable percentage multiplied by the smaller of line 24 or line 26a (see Instructions)				
c Subtract line 26a from line 24. If line 24 is not more than line 26a, skip lines 26c and 26e				
d Additional depreciation after 12/31/69 and before 1/1/76				
e Applicable percentage multiplied by the smaller of line 26c or 26d (see Instructions)				
f Section 291 amount (corporations only)				
g Add lines 26b, 26e, and 26f				
27 If section 1252 property: Skip this section if you did not dispose of farmland or if you are a partnership.				
a Soil, water, and land clearing expenses				
b Line 27a multiplied by applicable percentage (see Instructions)				
c Enter the smaller of line 24 or 27b				
28 If section 1254 property:				
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, and mining exploration costs (see Instructions)				
b Enter the smaller of line 24 or 28a				
29 If section 1255 property:				
a Applicable percentage of payments excluded from income under section 126 (see Instructions)				
b Enter the smaller of line 24 or 29a				

Summary of Part III Gains (Complete property columns A through D, through line 29b before going to line 30.)

30	Total gains for all properties. Add columns A through D, line 24	1,000
31	Add columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13. (See the Instructions for Part IV if this is an installment sale.)	1,000
32	Subtract line 31 from line 30. Enter the portion from casualty and theft on Form 4684, Section B, line 15. Enter the portion from other than casualty and theft on Form 4797, line 5	- 0 -

Part IV Election Not to Use the Installment Method (Complete this part only if you elect out of the installment method and report a note or other obligation at less than full face value.)

33	Check here if you elect out of the installment method	☐
34	Enter the face amount of the note or other obligation	\$
35	Enter the percentage of valuation of the note or other obligation	%

Part V Recapture Amounts Under Sections 179 and 280F When Business Use Drops to 50% or Less (See Instructions for Part V.)

	(a) Section 179	(b) Section 280F
36	Section 179 expense deduction or section 280F recovery deductions	
37	Depreciation or recovery deductions (see Instructions)	
38	Recapture amount. Subtract line 37 from line 36. (See Instructions for where to report.)	

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